The New Form ADV Part 2 Disclosure Requirements:
How They Relate to Your Investment Strategies and
Investment Product Due Diligence

Item 8 of the new Form ADV, Part 2A "requires that advisers describe their methods of analysis and investment strategies" and "that advisers explain the material risks involved for each significant investment strategy or method of analysis they use and particular type of security they recommend, with more detail if those risks are unusual." In the event of legal challenge, fiduciaries hire experts to meet their burden of persuasion as to the viability of their investment strategies and the sufficiency of their investment due diligence efforts. But the Daubert and Frye standards require expert's methods to possess either sound academic foundations or use back-testing of the investment strategy, in order to permit an expert to testify. Will your investment strategies and investment product due diligence stand up to judicial review? How can you enhance your disclosures regarding investment strategies and various risks of loss in Form ADV?

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Introduction

Some registered investment advisers appear to believe that "due diligence" is centered just on "investment product" due diligence (such as the evaluation of particular mutual funds) and "client suitability" (i.e., matching the needs of the clients to the investments provided). What's often overlooked is the need to justify the investment adviser's recommended "investment strategy," and to disclose fully that strategy's potential risks.

The SEC is increasing scrutiny of an investment adviser's due diligence efforts of investment strategies and products as a result of the rash of uncovered Ponzi schemes in recent years, including those of Madoff and Stanford. The lack of effective due diligence has also been questioned in other contexts, such as recommendations that investors purchase auction rate securities.

With such increased attention by securities regulators on due diligence, as well as the advent of the new Form ADV Part 2A, all investment advisers can expect greater scrutiny of their due diligence efforts and their required disclosures to clients.

This outline explores investment strategy due diligence, in the context of providing adequate disclosures in Form ADV, Part 2A. The outline first explores the fiduciary duty of due care, and in particular the "due diligence" obligation arising thereunder and the appropriate "standard of care." Then reviewed is the impact of the *Daubert* standard for the admissibility of expert testimony – planning ahead for possible justification of your investment strategy may well impact the nature and scope of your due diligence efforts.

This outline then turns to a discussion of various specific investment strategies, and reviews some of the recent academic evidence regarding these strategies. The outline concludes by reviewing several selected Form ADV Part 2A disclosures of investment strategies and risk of loss, and questions in some instances whether such disclosures were either appropriate or sufficient.

I. Sources of the Fiduciary Duty of Due Diligence, Generally

Investment advisers are fiduciaries of their clients under the Investment Advisers Act of 1940,[1] and as such they possess broad duties of due care and loyalty to their clients.[2] ERISA fiduciaries must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a reasonably prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aim.[3] When banks serve in a fiduciary capacity with respect to estate or guardianship accounts, or as trustee pursuant to a personal trust agreement, or with respect to investment management accounts[4], the banks and their trust or investment officers possess a general duty to invest prudently.[5]

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[1] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

[2] Study on Investment Advisers and Broker-Dealers: As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, by Staff of the U.S. Securities and Exchange Commission (Jan. 21, 2011) ("An investment adviser is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Included in the fiduciary standard are the duties of loyalty and care.") *Id.* at p. iii.

[3] ERISA Section 404(a). With respect to the duty of care, ERISA requires, among other things, that a fiduciary must diversify a plan's investments so as minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

[4] Investment accounts for which the bank has investment discretion or provides investment advice for a fee are defined as fiduciary accounts by the OCC in 12 CFR Part 9, Fiduciary Activities of National Banks, and are subject to the regulation.

[5] A "trustee who invests and manages trust property has a duty to comply with the prudent investor rule unless otherwise stated by the terms of the trust or provided by state law. This duty is tied to the duty to use reasonable care and skill to make the trust property productive. If a trustee has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, the trustee must use those special skills or expertise while administering the trust." Comptroller's Handbook, "Personal Fiduciary Services" (August 2002), at p.19, available at

Whether the source of fiduciary duties is the Advisers Act, ERISA, state common law[6], or other sources of law,[7] the broad fiduciary of due care, which encompasses due diligence, imposed upon fiduciaries obligations which extend far beyond the "reasonable basis" aspect of suitability possessed by broker-dealers.[8]

II. Defining the Fiduciary Duty of Due Diligence under Current Law

The duty of due diligence is ill-defined under the Advisers Act, but further guidance results from state common law (which informs the federal law). ERISA advisers are held to more defined standards for due diligence, as a result of the greater development of regulations, other guidance from EBSA, and case law arising thereunder.

A. Investment Advisers Act

1. SEC: "Reasonable Investigation" That Recommendations not be Based upon Materially Inaccurate Information

The SEC has seldom issued guidance with respect to the fiduciary standard of due care, particularly as it relates to investment due diligence. This may change, however. In January 2011, the SEC Staff Study, when suggesting the implementation of a "uniform fiduciary standard" for investment advisers and broker-dealers, recommended that the "Commission should engage in rulemaking and/or issue interpretive guidance addressing the components of the uniform fiduciary standard: the duties of loyalty and care."[9] In the Study, the SEC Staff

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http://www.occ.gov/static/publications/handbook/Pfsfinal.pdf. Of course, the terms of the trust agreement may alter the trustee's duties.

[6] State common law imposes broad fiduciary duties of due care, loyalty, and utmost good faith upon those in relationships of trust and confidence with their clients, such as investment advisers and financial planners. *See* Rhoades, "What are the Specific Fiduciary Duties of Those Providing Financial and Investment Advice to Retail Consumers?", an outline presented at the fi360 Conference, San Antonio, Texas (May 4-5, 2011).

[7] Fiduciary duties are imposed upon those serving as guardians, executors, trustees, attorneys-in-fact, and where fiduciary status or fiduciary duties are expressly accepted by contract. In addition, specific state statutes impose fiduciary duties in various contexts, such as those imposed upon viatical settlement brokers in many states, and those imposed upon some mortgage brokers in a few states.

[8] Under reasonable basis suitability, a broker-dealer has an affirmative duty to have an "adequate and reasonable basis" for any security or strategy recommendation that it makes. *See* Exchange Act Release No. 27535 (Dec. 13, 1989) (finding that the broker's recommendations violated suitability requirements because the broker did not have a reasonable basis for the strategy he recommended, wholly apart from any considerations relating to the particular customer's portfolio*). See also Hanly v. SEC,* 415 F.2d 589, 597 (2d Cir. 1969); *In the Matters of Walston & Co*., Exchange Act Release No. 8165 (Sept. 22, 1967) (settled order); *Michael F. Siegel*, 2007 NASD Discip. LEXIS 20 (2007). *See also* Regulatory Notice 09-25, "Proposed Consolidated FINRA Rules Governing Suitability and Know-Your-Customer Obligations" (and FINRA Rule 2111.05 (effective Oct. 7, 2011) ("The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least *some* investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.")

Additional specific disclosure, due diligence, and suitability requirements are imposed upon broker-dealers with regard to certain securities products, including penny stocks, options, mutual fund share classes, debt securities and bond funds, municipal securities, hedge funds, direct participation programs, variable insurance products, and non-traditional products, such as structured products and leveraged and inverse exchange-traded funds. *See* SEC Staff Study, *supra* n.2, at footnotes 292-9.

[9] SEC Staff Study, *supra* n.2, p.vi. The SEC Staff further opined: "Minimum baseline professionalism standards could include, for example, specifying what basis a broker-dealer or investment adviser should have in making a recommendation to an investor."

opined that an "an investment adviser's duty of care requires it to 'make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information.'"[10] In other words, investment advisers must possess a "reasonable basis for advice."[11]

Under this very limited due diligence requirement, an investment adviser must "reasonably investigate" to ensure that his, her or its recommendations are not based upon false information. If the investment adviser later discovers information relating to a recommendation previously made, which should cause the investment adviser to become suspicious of the previous information relied upon by the investment adviser, the investment adviser should undertake an investigation.[12] In addition, an investment adviser's recommendations must be "suitable."[13]

Earlier the SEC opined in the context of rulemaking for hedge fund registration that the "fiduciary duty requires advisers to manage their clients' portfolios in the best interest of clients, but not in any prescribed manner. A number of obligations to clients flow from this fiduciary duty, including the duty … to have a reasonable basis for client recommendations."[14]

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[10] SEC Staff Study, *supra* n.2, pp.120-1, *quoting Concept Release on the U.S. Proxy Syste*m, Investment Advisers Act Release No. 3052 (July 14, 2010) ("Release 3052") at 119. The SEC staff also noted that "[t]he duty of care also obligates investment advisers to seek best execution of clients' securities transactions when they have the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts)." SEC Staff Study at p.121. The SEC Staff noted, however, that the duty of due care requires greater articulation, stating: "In evaluating the regulation of investment advisers and broker-dealers, the Staff believes that it could be useful to develop rules or guidance on the minimum requirements that are fundamental to a duty of care under the uniform fiduciary standard. Professional standards under the duty of care could be developed regarding the nature and level of review and analysis that broker-dealers and investment advisers should undertake when making recommendations or otherwise providing advice to retail customers ... Any such rules or guidance could take into account long-held Advisers Act fiduciary principles, such as the duty to provide suitable investment advice (e.g., with respect to specific recommendations and the client's portfolio as a whole) and to seek best execution.556 Detailed guidance in this area has not been a traditional focus of the investment adviser regulatory regime ... the Staff recommends that any rulemaking or guidance explicitly provide that it establishes only minimum expectations for the appropriate standard of conduct and does not establish a safe harbor or otherwise prevent the Commission from applying a higher standard of conduct based on specific facts and circumstances." *Id.* at 122-3.

[11] *In the Matter of Alfred C. Rizzo*, Advisers Act Release No. 897 (Jan 11, 1984) (investment adviser lacked a reasonable basis for advice and could not rely on "incredible claims" of issuer); *In the Matter of Baskin Planning Consultants, Ltd.*, Advisers Act Release 1297 (Dec. 19, 1991) (adviser failed adequately to investigate recommendations to clients).

[12] *See* discussion of *Hennessee Group*, *infra* at fn.31.

[13] *See Suitability of Investment Advice Provided by Investment Advisers*, Investment Advisers Act Release No. 1406 (Mar. 16, 1994). "In Release No. 1406, the SEC proposed a rule under the Act's anti-fraud provisions requiring advisers give clients only suitable advice. Although the rule was never adopted, the SEC staff takes the position that the rule would have codified existing suitability obligations of advisers and, as a result, the proposed rule reflects the current obligation of advisers under the Act. Suitability obligations do not apply to impersonal investment advice, and compliance with the obligation is evaluated in the context of a client's overall portfolio. "Thus, inclusion of some risky securities in the portfolio of a risk-averse client may not necessarily be unsuitable." *Id.* The SEC has instituted enforcement actions against advisers that provided unsuitable investment advice. *See In the Matter of Westmark Financial Services*, Investment Advisers Act Release No. 1117 (May 16, 1968) (financial planner recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes); *In the Matter of George Sein Lin*, Investment Advisers Act Release No. 1391(Nov. 9, 1993) (adviser with discretionary authority invested funds of clients desiring low risk investment in uncovered option contracts and used margin accounts)." Robert E. Plaze, The Regulation of Investment Advisers by The Securities and Exchange Commission (Nov. 22, 1986), available at http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042006.pdf.

[14] SEC Release No. IA-2266 ("Registration Under the Advisers Act of Certain Hedge Fund Advisers").

Despite the foregoing general language used by SEC Staff, further delineation of the fiduciary duty of due care, with respect to investment strategies and investment product selection, can be gleaned from prior rules and cases, including the Form ADV Part 2A requirements and recent decisions arising post-Madoff.

2. The Form ADV Part 2A Requirements: Extensive Investment Strategy and Investment Security Risk Disclosures are Now Required

Despite the reluctance of SEC Staff in its January 2011 Study to become more specific regarding an investment adviser's duty of due care, in a prior 2010 Final Rule the SEC upped the ante for investment advisers. The new Form ADV, Part 2A Instructions[15] require the RIA to "describe the methods of analysis and investment strategies you use in formulating investment advice or managing assets." And, the SEC also requires that, for "each significant investment strategy or method of analysis you use, explain the material risks involved." Moreover, Form ADV Part 2A requires additional discussion of risks, in detail, "if the method of analysis or strategy involves significant or unusual risks." Finally, if the RIA recommends "primarily a particular type of security, explain the material risks involved. If the type of security involves significant or unusual risks, discuss these risks in detail."[16]

The SEC further stated that it "we would view a method of analysis or strategy as significant if more than a small portion of the adviser's clients' assets are advised using the method or strategy."[17]

Not all risks relating to the use of particular investment strategies, nor particular type of securities, need be disclosed – only those risks which are "material." A fact is "material" if it would matter to the client or prospective client.[18] Stated differently, a material fact is "anything which might affect the (client's) decision whether or how to act."[19] "The standard of materiality is whether or not a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest."[20] In the context of omissions to state a material fact, the courts have held that the "omission had to satisfy one of two tests: (1) whether there was a substantial likelihood that the omission would have 'actual significance in the deliberations of a reasonable investor,' or (2) whether there was a substantial likelihood that the omission 'significantly altered the 'total mix' of information made available.'"[21]

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[15] "Item 8 Methods of Analysis, Investment Strategies and Risk of Loss

A. Describe the methods of analysis and investment strategies you use in formulating investment advice or managing assets. Explain that investing in securities involves risk of loss that clients should be prepared to bear.

B. For each significant investment strategy or method of analysis you use, explain the material risks involved. If the method of analysis or strategy involves significant or unusual risks, discuss these risks in detail. If your primary strategy involves frequent trading of securities, explain how frequent trading can affect investment performance, particularly through increased brokerage and other transaction costs and taxes.

C. If you recommend primarily a particular type of security, explain the material risks involved. If the type of security involves significant or unusual risks, discuss these risks in detail."

[16] SEC Release No. IA-3060, Amendments to Form ADV, p. 20.

[17] *Id.*, p.21.

[18] Unlike the common law, the Advisers Act has been construed to apply disclosure requirements as to not just clients but also as to prospective clients. The SEC follows this long-standing principle in its new Rule 204-3, which requires a registered adviser to furnish each client and prospective client with a written disclosure statement – which may be either a copy of the adviser's completed Part 2A or a written document containing the information required by Part 2A.

[19] *Allen Realty Corp. v. Holbert*, 318 S.E.2d 592, 227 Va. 441 (Va., 1984).

[20] *S.E.C. v. Ki.W. Brown and Co.,* 555 F.Supp.2d 1275 (S.D. Fla., 2007), *citing SEC v. Steadman*, 967 F.2d 636, 643 (D.C.Cir.1992).

[21] *Capital Dist. Physician's Health Plan v. O'Higgins*, 939 F. Supp. 992, 1005 (N.D. N.Y., 1996*), citing TSC Industries v. Northway, Inc.*, 426 U.S. 438, 450, 96 S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976).

While "materiality" is the general standard for disclosure, the SEC also requires disclosure in Form ADV Part 2A of "significant or unusual" risks. The SEC explained that this additional requirement "is intended to elicit from the adviser disclosure of significant risks associated with using a particular investment strategy or recommending a particular type of security that otherwise would not be apparent to the client from reading the adviser's brochure."[22]

This obligation of disclosure of the material risks of the advisers' investment strategies, within Form ADV Part 2A, involves those "strategies that will be relevant to most clients, regardless of whether they use one strategy or many strategies." However, the SEC noted that "the brochure may not always be the best place for a multi-strategy adviser to disclose risks associated with all of its methods of analysis or strategies. Disclosure of that information likely would lengthen the brochure unnecessarily given that different clients will be pursuing different strategies, each of which poses specific and different risks."[23] Accordingly, if an investment adviser promotes a specific investment strategy to only some clients, and not "most clients," disclosure of that specific investment strategy within Form ADV Part 2A may not be required. However, it is clear that the disclosure obligation still exists. As the SEC notes: "Items in Part 2 of Form ADV may not … identify all material disclosure that an adviser may be required to provide clients. As a result, delivering a brochure prepared under Form ADV's requirements may not fully satisfy an adviser's disclosure obligations under the Advisers Act."[24]

The SEC further also noted that "an adviser may have an obligation (independent of Part 2A) to disclose material information about its policies regarding the management of cash balances where the omission of such information would constitute a breach of the adviser's fiduciary duty (e.g., where the cash is not managed in the best interest of the client)."[25]

On March 18, 2011, the SEC Staff elaborated upon the investment strategy disclosure obligations in its "Staff Responses to Questions About Part 2 of Form ADV"[26]:

> **Question II. 4**
>
> Q: Item 8.B of Part 2A requires an adviser to explain the material risks for each significant investment strategy or method of analysis the adviser uses. Does Item 8.B require an adviser that uses pooled investment vehicles as a significant investment strategy or method of analysis to duplicate the risk disclosures contained in a prospectus or other offering document for the pooled investment vehicle?
>
> A: An adviser may satisfy the requirement of Item 8.B by providing a brief explanation of the material risks for each strategy and referring clients to the prospectus, offering memoranda, or other documents that a client participating in the pool will or has received that set out a more detailed discussion of risks.
>
> **Question II. 5**
>
> Q: Item 8.B of Part 2A requires an adviser to explain the material risks for each significant investment strategy or method of analysis the adviser uses. Does Item 8.B require an adviser

[22] *Id.* at p.22.

[23] *Id.* at pp.20-1.

[24] *Id.* at p.4, fn.7. *See* Instruction 3 of General Instructions for Part 2 of Form ADV; rule 204-3(f).

[25] *Id.* at p.22, noting also that "An adviser that is also registered as a broker-dealer may also have disclosure obligations relating to its cash balance practices arising under Commission and self-regulatory organization requirements. *See* NYSE information Memo No. 05-11 (Customer Account Sweeps to Banks) (Feb. 2005).

[26] Available at http://www.sec.gov/divisions/investment/form-adv-part-2-faq.htm.

that uses multiple investment strategies or methods of analysis to explain the material risks for each significant investment strategy or method of analysis in the brochure?

A: Yes, an investment adviser using multiple significant investment strategies or methods of analysis must explain the risks for each significant investment strategy or method of analysis it uses. An adviser using multiple strategies or methods of analysis may satisfy the requirements of Item 8.B by summarizing the strategies and methods and their material risks and referring clients and prospective clients to a separate disclosure document that the client has or will receive that sets out a more detailed explanation of the material risks of investment strategies or methods of analysis that are or will be used to manage the client's account.

3. High Level of Disclosure Burden Exists When High-Risk Investment Strategies are Involved

A 2009 Complaint[27] by the SEC against an investment adviser and its principle, while filed prior to the Form ADV Part 2A revisions, indicated a heavy burden of disclosure in a situation involving a high-risk investment strategy. The Complaint alleged:

> Gendreau managed client funds by employing high-risk investment strategies. Generally, Gendreau encouraged his clients to become highly leveraged in various ways regardless of the clients' risk tolerance. Gendreau maximized his clients' leverage by: (1) using significant margin (resulting in margin equity ratios of about 50%); (2) encouraging clients to increase their investments by borrowing against their homes; (3) persuading clients to invest with money withdrawn or borrowed from their retirement accounts so that it could be traded on margin; and (4) investing heavily in leveraged mutual funds and ETFs.

The investment adviser made risk disclosures in its Form ADV Part II narrative. As the Complaint alleged:

> G&A's Form ADV provided to clients [stated] only that 'investment methods involve a Beta 2 to 4 times higher than the [S&P 500],' which G&A stated meant that 'when market conditions are favorable, clients can achieve greater returns than the [S&P 500]' and 'that when market conditions are not favorable, clients may lose more than the [S&P 500] declines."

However, despite the foregoing disclosure, the SEC's complaint alleged that the investment adviser, G&A, "failed to provide adequate disclosures of the risks associated with the investment strategy." The SEC also noted: "When Gendreau used his one-size-fits-all investment strategy, he knew it was unsuitable for many of his clients because of their lower risk tolerance, yet he failed to adequately disclose that his strategy was high-risk."

There were other allegations in the complaint which indicate actual misrepresentations of the strategies as "no risk" or "guaranteed." In the end, Gendreau was barred from association with an investment adviser.[28]

4. Failure to Undertake the Due Diligence Which is Represented to be Undertaken

Not surprisingly, if an investment adviser advertises or represents that it undertakes a certain level of due diligence, and then fails to undertake same, such failure to conduct due diligence has repeatedly been found to be a violation of the Advisers Act Section 206(2).[29] In other words, and at least to a degree, the investment

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[27] Complaint for Violations of the Federal Securities Laws, SEC vs. Gendreau & Associates, Inc. and Jacques R. Gendreau, Case No. CF-09-03697, US District Court, Central District of California, filed May 26, 2009, available at http://ocbiz.freedomblogging.com/files/2009/05/gendreau-complaint.pdf.

[28] SEC Rel. IA-3162 (Feb. 17, 2011), available at http://sec.gov/litigation/admin/2011/ia-3162.pdf.

[29] Section 206 of the Advisers Act makes it unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly:

(1) To employ any device, scheme, or artifice to defraud any client or prospective client;

adviser's fiduciary duty of due diligence is contoured, at least to higher levels, where there is a representation that a higher level of due diligence is undertaken.

A recent enforcement action illustrates the principle:

> During the relevant period, Morgan Stanley's disclosure materials described the advisory services it provided which included assisting clients in identifying money managers to manage clients' assets. Morgan Stanley disclosed the detailed due diligence process it followed to select and approve money managers for participation in the firm's managed account program. According to its disclosure materials, Morgan Stanley financial advisers selected money managers from this approved list of managers to recommend to clients based on the client's investment profile and objectives.
>
> Contrary to its disclosures, Morgan Stanley recommended to Nashville advisory clients certain money managers who were not approved for participation in Morgan Stanley's advisory programs and had not been subject to the firm's due diligence review.[30]

In another recent example, in the *Hennessee Group LLC* April 2009 administrative order, the SEC found a breach of fiduciary duties by an investment adviser and its chief investment officer, Charles Grandante, regarding investments made by the firm's clients in Bayou hedge funds. The administrative order observed both a failure to undertake the due diligence processes promoted by the firm, as well as a failure to investigate when suspicious information about the hedge fund manager became known:

> Hennessee Group is a hedge fund consultant and investment adviser that recommends hedge funds for client investment and monitors those investments on its clients' behalf. In the course of soliciting clients, Hennessee Group, by and through its principal, Charles Gradante, made numerous representations concerning the quality and rigor of its due diligence process for evaluating hedge funds. Hennessee Group also routinely represented to clients and prospective clients that it would not recommend investments in hedge funds that did not satisfy all phases of its due diligence …
>
> [A]pproximately forty clients of Hennessee Group invested a total of over $56 million in the Bayou funds after receiving Hennessee Group's recommendations. Most of those monies were lost and dissipated by Bayou's principals …
>
> Hennessee Group and Gradante, in their capacities as investment advisers, owed fiduciary duties to their clients to perform the services that they represented they would provide and to disclose all material departures from the representations that they made to their clients …
>
> Hennessee Group promoted its process for evaluating and selecting hedge funds as the "Five Level Due Diligence Process" … that process included:
>
>> (ii) a face-to-face initial interview with the fund manager that covered numerous topics such as the background of the fund manager, the fund's "portfolio construction and attributes" and "risk management" principles, and the name and contact information of the fund's outside audit firm;

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(2) To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

15 U.S.C. § 80b-6. Scienter is required for a violation of Section 206(1) but not for a violation of Section 206(2). *See Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963).

[30] *In the Matter of Morgan Stanley & Co.,* SEC Release IA-2904 (July 20, 2009).

> (iii) a detailed review and analysis of the fund's investment portfolio, trading practices, and risk management discipline, generally based on prime brokerage reports sufficient to reflect the fund's actual activity over a given period;

> Hennessee Group maintained detailed procedures on how the five levels of due diligence that were described in its marketing materials and website were to be conducted … Hennessee Group did not obtain or evaluate any quantitative information about Bayou's portfolio characteristics, investment and trading strategies, or risk management discipline …

> Hennessee Group and Gradante failed to conduct two of the five elements of the due diligence review that they had represented to their clients they would undertake. In addition, Hennessee Group and Gradante failed to adequately respond to information that they received that suggested that the identity of Bayou's outside auditor was in doubt and that there existed a potential conflict of interest between one of Bayou's principals and the purported outside auditor of Bayou. Hennessee Group and Gradante breached their fiduciary duties to their investment advisory clients.[31]

In another recent enforcement proceeding, involving misrepresentations as to the scope of due diligence undertaken:

> The evidence is overwhelming that Giesige breached the fiduciary duty she owed to her investment adviser clients, almost all of whom were people of moderate means who are fairly conservative in their level of risk tolerance. Acting with scienter or with utter recklessness, Giesige advised clients to invest their funds, including their retirement funds, in what she represented to them was a good investment with no undue risk. However, Giesige lied to her clients, because, as she testified, she considered Carolina Development to be a substantially risky investment … the evidence is that Giesige lied in giving her customers the belief that she had done a due diligence investigation of Carolina Development and that she knew about the IPO process.[32]

5. A Heightened Scope for Hedge Fund Due Diligence?

As illustrated above, due diligence can vary depending upon the representations of the investment adviser. Due diligence obligations might also vary depending upon the nature of the investment strategy or product being reviewed.

For example, hedge funds, due to their lack of transparency in most instances, appear to present greater opportunities for fraud. As a result, investment advisers' due diligence efforts should also be more extensive. While the actual scope of these due diligence efforts will vary with the circumstances, a recent report, and a recent article, suggest the extensiveness of due diligence which may be required.

A recent report from a Presidential study group indicated in a recent report on best practices for hedge fund advisers the "thorough" due diligence which investors (and presumably investment advisers, as well) should undertake before investing in hedge funds:

> Investors should conduct thorough due diligence in the market place on the reputation, experience and background of hedge fund managers and the key principals in the firm. Investors should employ as broad a range of resources as practicable, including industry

[31] *In the Matter of Hennessee Group LLC and Charles J. Gradante*, SEC Rel. No. IA-2871 (April 22, 2009).

[32] *In the Matter of Maria T. Giesige*, INITIAL DECISION RELEASE NO. 359, ADMINISTRATIVE PROCEEDING FILE NO. 3-12747 (Oct. 7, 2008).

> contacts references, professional background searches, regulatory registrations, disciplinary history, and other research tools.[33]

The entire activities relating to hedge fund due diligence may be beyond the capacity of many investment advisers, and even many broker-dealers, as suggested by one recent law firm:

> While many broker-dealers have skilled analysts capable of assessing an investment adviser's or commodity pool operator's business acumen, its prior performance, and its investment strategy, there are many components of an independent review by a law firm that may not be covered by in-house personnel. These include a review of key agreements and related disclosure; a review of organizational documents and minutes; verification of relationships with and reference calls to auditors, custodians, and administrators; a review of regulatory matters, including compliance policies and procedures and regulatory exam results; background checks; litigation searches and analysis; and an overall review of the adequacy of offering disclosure. While no set of procedures can guarantee that fraud will be detected, an appropriate investigation greatly increases the likelihood that problem programs and sponsors will be avoided.[34]

Where an investment advisor recommends a hedge fund without conducting sufficient due diligence, an investor's breach of fiduciary duty claim arises in the securities context.

B. ERISA's Due Diligence Obligations

"It is by now black-letter ERISA law that "the most basic of ERISA's investment fiduciary duties [is] the duty to conduct an independent investigation into the merits of a particular investment*." In Re Unisys Savings Plan Litig.*, 74 F.3d 420, 435 (3d Cir.), cert. denied, ___ U.S. ___, 117 S.Ct. 56, 136 L.Ed.2d 19 (1996). "The failure to make any independent investigation and evaluation of a potential plan investment" has repeatedly been held to constitute a breach of fiduciary obligations. *Whitfield v. Cohen*, 682 F.Supp. 188, 195 (S.D.N.Y.1988); see Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 918 (8th Cir.1994) ("a fiduciary is obligated to investigate all decisions that will affect the pension plan"); *Mason Tenders*, 909 F.Supp. at 887 ("[t]he failure to make any independent investigation and evaluation of a potential plan investment is a breach of fiduciary obligations")." *Liss v. Smith*, 991 F.Supp. 278, 297 (S.D.N.Y., 1998)

Section 404(a)(1)(C) requires fiduciaries to discharge their duties "by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." 29 U.S.C. § 1104(a)(1)(C). "Under the duty of diversification, the trustee should not normally invest all or an unduly large portion of plan funds in a single security, or in any one type of security, or even in various types of securities that depend on the success of one enterprise." *Bruner v. Boatmen's Trust Co.*, 918 F.Supp. 1347, 1353 (E.D.Mo.1996). Breach of the duty to diversify constitutes an independent basis of liability, separate from a breach of the general duty of prudence. *Dardaganis*, 889 F.2d at 1241; *Marshall v. Glass/Metal Ass'n and Glaziers and Glass-workers Pension Plan*, 507 F.Supp. 378, 383-84 (D.Haw.1980). "Congress chose not to legislate a specific percentage limit on any one investment. Instead, it imposed a requirement of diversification that depends upon the facts and circumstances surrounding each plan and investment." Id. at 383; *Lanka v. O'Higgins*, 810 F.Supp. 379, 387 (N.D.N.Y. 1992); *Reich v. King*, 861 F.Supp. 379, 383 (D.Md.1994) ("King I"). That is, there is no "per se" violation of Section 404(a)(1)(C), as each case turns on its unique facts and circumstances. *Id.* at 385. Once plaintiffs have established a prima facie case of failure to diversify, the burden

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[33] Asset Managers' Committee to the President's Working Group on Financial Markets, *Principles and Best Practices for Hedge Fund Investors / Report of the Investor's Committee To The President's Working Group On Financial Markets* (January 15, 2009) at p. 21, available at http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf.

[34] Snyder Kearney LLC, "Financial Product and Money Manager Due Diligence," available at http://www.snyderkearney.com/articles/Financial_Product_and_Money_Manager_Due_Diligence.pdf.

of persuasion shifts to defendants to show that the investments at issue were nevertheless "clearly prudent" under the circumstances. *Reich v. King*, 867 F.Supp. 341, 343 (D.Md.1994) (King II); *Lank*a, 810 F.Supp. at 386-87." *Liss v. Smith*, 991 F.Supp. 278, 301 (S.D.N.Y., 1998)

C. Trustee's Due Diligence Obligations

Generally, a trustee is under a duty to employ diligence and prudence in the management of the trust estate (*In re Marine Midland Bank*, 127 AD2d 999 [4th Dept 1987]). Unless the terms of the trust agreement otherwise provide, a trustee generally must act in accordance with the Prudent Investor Rule, as adopted by the jurisdiction governing the choice of law applicable to the trust or its administration. Moreover, a professional trustee, such as a bank, "professional must exercise that degree of care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field.... It is therefore the degree of care, knowledge and skill expected of professional investment advisors to which we must look for the standard of care."[35]

Where the trustees lack the requisite knowledge, experience and expertise to make the necessary decisions with respect to investments, their fiduciary obligations require them to hire independent professional advisors.[36] (*Mason Tenders*) ("a trustee has a duty to seek independent advice where he lacks the requisite education, experience and skill"); *Trapani v. Consolidated Edison Employees' Mutual Aid Society*, 693 F.Supp. 1509, 1516 (S.D.N.Y.1988) ("A fiduciary who is ill-equipped to evaluate a claim may have a duty to seek outside assistance."); see also 29 U.S.C. § 1104(a)(1)(B) (standard of care measured against "prudent man ... familiar with such matters"); *Katsaros,* 744 F.2d at 279 ("[a] trustee's lack of familiarity with investments is no excuse"). This does not mean that all trustees must hire investment advisors or asset managers with respect to every investment decision. Indeed, ultimate decision-making authority and responsibility for investments rests with the trustees. *See Mason Tenders*, 909 F.Supp. at 886 (trustee must make own decision based on advice). The need for independent advice will depend on the factual circumstances of each case*." Liss v. Smith*, 991 F.Supp. 278, 297 (S.D.N.Y., 1998).

D. The Investment Adviser's Due Diligence under State Common Law

As stated previously, investment advisers also owe a common law duty of due care to their clients. The Advisers Act does not (generally) preempt state common law, and as a result investment advisers (for non-ERISA accounts) must look to the higher standard which may be imposed.[37] In other words, over-reliance should not occur as to SEC no-action letters or rule-making or case law arising under the Advisers Act, for the SEC sets a floor, not the ceiling, as to the fiduciary obligations of investment advisers. In contrast, ERISA does preempt state common law with respect to the obligations imposed upon investment advisers to ERISA accounts.

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[35] Robertson v. Central Jersey Bank & Trust Co., 47 F.3d 1268 (C.A.3 (N.J.), 1995), citing Erlich, 505 A.2d at 232

[36] See United States v. Mason Tenders Dist. Council of Greater New York, 909 F.Supp. 882, 886 (S.D.N.Y.1995). The Uniform Prudent Investor Act now encourages fiduciaries to engage in appropriate delegation to qualified professionals. "This statutory policy should be adopted by nonprofessional trustees with alacrity, as a means to reduce the fiduciary's potential exposures for unsuccessful investment decisions." John A. Hartog, Paul Sanderson, Delegation of Fiduciary Power under the California Prudent Investor Act, available at http://www.jahartog.com/forms/cpiaar~1.pdf. Moreover, "a trustee who fails to seek advice with respect to matters about which the trustee lacks skill or knowledge may be liable for failure to exercise proper care in making an investment". *See* "A Trustee's Crime and Punishment: Managing Fiduciary Liability Under the California Uniform Prudent Investor Act", J. Hartog and P. Sanderson, California Trusts and Estates Quarterly, Vol. 4, No. 2, Summer, 1998.

[37] The SEC's Investment Advisory "Investor as Purchaser Subcommittee" noted that while the federal fiduciary duty applies only under the Advisers Act, a non-federal fiduciary duty can apply nonetheless in other contexts outside of the Advisers Act. Memorandum from the Investor as Purchaser Subcommittee, to the SEC Investor Advisory Committee 7 (Feb. 15, 2010), available at http://www.sec.gov/spotlight/invadvcomm/iacmemofiduciaryduty.pdf.

Fiduciary obligations arising under state common law, as applicable to investment advisers, are derived from several different sources of law, including aspects of trust law and agency law.[38]

Under the common law, an investment adviser acts as agent of its clients and, accordingly, must manage the investment of client funds with care, competence, and diligence.[39] The Restatement (Third) Agency provides a summary of the duties of care owed by every agent to his or her or its principal (i.e., client):

> Subject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances. Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence. If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.[40]

The comments to the Restatement (Third) Agency's general rule, stated above, provide further guidance as to the scope of due diligence normally required:

> An agent's duty of diligence requires the agent to bring the agent's competence to bear on matters undertaken on behalf of the principal … Although an agent has a duty of diligence, that duty is to make reasonable efforts to achieve a result and not a duty to achieve the result regardless of the effort, risk, and cost involved. If an agent makes a reasonable effort, the agent is not subject to liability to the principal if the effort fails to accomplish the end desired by the principal.[41]

E. Limiting the Fiduciary Duty of Due Care through Hedge Clauses

Under the common law of agency a principal and agent "may establish benchmarks or other measures for the effort and skill to be expected from the agent."[42] In contrast, however, Section 215(a) of the Investment Advisers Act voids any provision of a contract that purports to waive compliance with any provision of the Act.

One of the contexts in which Section 215(a) arises is considering whether the use of a "hedge clause" is valid. A typical "hedge clause" in an investment advisory agreement is structured as an exculpation of the adviser from liability and/or as indemnification of the adviser by the advisory client unless the adviser has been grossly negligent or has engaged in reckless or willful misconduct, illegal acts or acts outside the scope of its authority. Often, hedge clauses are followed by "non-waiver disclosure" that explains that the client may have certain legal rights, generally arising under federal and state securities laws, notwithstanding the hedge clause that have not been waived.

Despite over seven decades of the application of Section 215(a) to investment advisers, the "[SEC] staff has never clearly articulated the scope of the rights of an advisory client under the federal securities laws that may not be contractually waived or limited. Indeed, many investment advisers take the position that there are a wide range of activities and issues that fall outside of this scope and for which responsibility may be properly

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[38] Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (C.A.11 (Fla.), 1987) ("The fiduciary concept derives from trust and agency principles. Actions contrary to the duties of loyalty and care are remedied by giving the beneficiary of the relationship the right to recover for the fiduciary's breach.")

[39] *See Aden v. Fortsh*, 169 N.J. 64, 776 A.2d 792 (N.J., 2001) ("Our jurisprudence properly insists that fiduciaries, on whom members of the public rely for services and advice, conduct themselves with diligence and care.") *Id. at 809.*

[40] Restatement (Third) Agency, at § 8.08, Duties of Care, Competence, and Diligence (American Law Institute, 2007).

[41] *Id.*, at § 8.08, cmt. d.

[42] *Id.*, at § 8.08, cmt. a, further providing: "For example, a contract between principal and agent may specify measures for the effort that the agent has duty to expend in pursuing the principal's objectives … A contract may also, in appropriate circumstances, raise or lower the standard of performance to be expected of an agent."

limited pursuant to a contractual hedge clause. In addition, an investment adviser and its client may agree to certain corrective actions that may be beneficial to the investment adviser so long as the client is fully informed, sophisticated, and agrees contractually in writing."[43]

Often this author sees within Form ADV disclosures language which purports to limit an investment adviser's liability for actions taken, or not taken, with respect to management of the investment portfolio. The use of hedge clauses in Form ADV and in investment advisory contracts with clients should only be undertaken with great caution, and in some instances their use may effect either a denial or registration and/or a violation of federal or state securities laws, to the effect that the investment adviser has sought to mislead clients in violation of the adviser's fiduciary duties. Investment advisers should ascertain the sophistication of their clients, and the depth of disclosure provided, before seeking to include a hedge clause in the agreement with the client. In addition, investment advisers who utilize hedge clauses should seek to utilize plain English, review the hedge clause with the client in an in-person meeting,[44] and provide disclosures that the client may still possess a right of action under securities laws.[45]

Here are some examples of hedge clauses which have been deemed prohibited, or at least inappropriate, by either federal or state securities regulators:

> Waivers of liability for ordinary negligence were previously prohibited, but now depend upon the facts and circumstances presented.[46]
>
> Waivers of liability for acts done in "bad faith" or pursuant to "willful misconduct"[47]

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[43] K&L Gates, "Hedge Clauses in Advisory Contracts" (Feb. 2007), available at http://www.klgates.com/files/Publication/c774d967-4a8d-4bc1-95b0-1251cb73c809/Presentation/PublicationAttachment/51696336-db02-4bbd-bce1-03132f837c4c/HFA0207.pdf.

[44] "[W]e note that an investment adviser has an affirmative duty to explain a hedge clause if the investment adviser believes or has reason to believe that a particular client, in light of his or her unique circumstances, would be likely to be misled by it." *Heitman Capital Management, LLC* no-action letter (Feb. 12, 2007), available at http://www.sec.gov/divisions/investment/noaction/2007/heitman021207.pdf.

[45] *See Heitman, supra n.44.*

[46] In a 1972 no-action letter, the SEC opined that a hedge clause which attempted to waive liability for acts constituting "ordinary negligence" was misleading, notwithstanding further language in the advisory agreement which specifically disclaimed any waiver for "acts or omissions which constitute fraudulent representations under applicable State or Federal common law or statute, gross negligence, willful misconduct or violations of the Investment Advisers Act of 1940, [or] any other applicable State or Federal statute or regulation thereunder." *But see Heitman* no-action letter, *supra* n.43 ("We believe that whether an investment adviser that uses hedge clauses in investment advisory agreements that purport to limit that adviser's liability to acts of gross negligence or willful malfeasance violates sections 206(1) and 206(2) of the Advisers Act would depend on all of the surrounding facts and circumstances. In making this determination, we would consider the form and content of the particular hedge clause (e.g., its accuracy), any oral or written communications between the investment adviser and the client about the hedge clause, and the particular circumstances of the client. For instance, when a hedge clause is in an investment advisory agreement with a client who is unsophisticated in the law, we would consider factors including, but not limited to, whether: (i) the hedge clause was written in plain English; (ii) the hedge clause was individually highlighted and explained during an in-person meeting with the client; and(iii) enhanced disclosure was provided to explain the instances in which such client may still have a right of action. In addition, we would consider the presence and sophistication of any intermediary assisting a client in his dealings with the investment adviser and the nature and extent of the intermediary's assistance to the client.")

[47] The SEC found to be misleading another hedge clause which sought to limit liability to acts done in bad faith or pursuant to willful misconduct but also explicitly provided that rights under state or federal law cannot be relinquished. In reaching this conclusion it was noted that "it is unlikely that a client who is unsophisticated in the law would realize that he may have a right of action under federal or state law even where his adviser has acted in good faith." *First National Bank of*

> "Adviser shall not be liable for any loss or depreciation in the value of the account unless it shall have failed to act in good faith or with reasonable care."[48]

> "While Adviser agrees to use its best efforts in the management of the portfolio, [Adviser] shall not be responsible for errors in judgment or losses incurred on investments made in good faith, and its liability shall be limited expressly to losses resulting from fraud or malfeasance, or from violation of applicable law."[49]

> "It is understood that we will expend our best efforts in the supervision of the portfolio, but we assume no responsibility for action taken or omitted in good faith if negligence, willful or reckless misconduct, or violation of applicable law is not involved."[50]

However, not all hedge clauses are prohibited. For example, federal and state securities regulators would likely possess little concern over a *force majeure* clause, a common clause in contracts that essentially frees both parties from liability or obligation when an extraordinary event or circumstance beyond the control of the parties, such as a war, strike, riot, crime, or an event described by the legal term "act of God" (such as flooding, earthquake, or volcanic eruption), prevents one or both parties from fulfilling their obligations under the contract. However, *force majeure* is not intended to excuse negligence or other malfeasance of a party, as where non-performance is caused by the usual and natural consequences of external forces (for example, predicted rain stops an outdoor event), or where the intervening circumstances are specifically contemplated.

F. Limiting Duties through Defining the Scope of the Engagement

While broad waivers of the fiduciary duties of due care, loyalty and utmost good faith are disfavored by the courts, it is permissible to limit, at least to a degree, the scope of an engagement.[51] For example, it would be permissible to seek a waiver of the prudent investor rule, which might be assumed to be applicable by the client, if the client seeks the investment adviser to manage a discrete portfolio consisting only of equity securities, or only of fixed income securities, which is not the entire client's portfolio.

However, it must be inquired as to what disclosures would be required should the investment adviser seek to limit the scope of the engagement beyond that which might be either reasonable or typical in the industry. As noted in the context of a report dealing with obligations arising under ERISA, clients of fiduciaries (who may be plan fiduciaries themselves, in the ERISA context) may possess difficulties negotiating scope of engagement issues:

Akron (available Feb. 27, 1976); *See also Municipal Advisory Council of Texas* (available Oct. 23, 1975); *Omni Management Corporation* (available July 15, 1974).

48 "Investment Advisers Cautioned on Use of Hedge Clauses," by Connecticut Department of Banking, Securities and Business Investment Division, in which the staff opined that the Connecticut Uniform Securities Act's antifraud provisions "may be violated if an advisory client is lead to believe that the client has either waived a right of action he or she may have under state or federal securities law or common law, or is misled as to the nature of those rights." Available at http://www.ct.gov/dob/cwp/view.asp?a=2252&q=299222.

49 *Id.* The state securities regulator's staff noted that the "adviser's statement that it assumes liability for 'violation of applicable law' only compounded the problem since it was unlikely that the client would realize that 'applicable law' does, under several circumstances, provide a right of action for even good faith 'errors in judgment.'

50 *Id.* The State securities regulator's staff noted that "an investment adviser is a fiduciary subject, under certain circumstances, to liability even when he has acted in good faith and without evil intent."

51 Commissioner Walter noted that what is required under the fiduciary duty depends on the scope of the engagement. Elisse B. Walter, SEC Comm'r, Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization?, Address at the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 5, 2009), available at http://www.sec.gov/news/speech/2009/spch050509ebw.htm.

> [O]ne of the more difficult issues facing trustees in retaining service providers was to always be sure that the scope of the engagement was appropriate for the type of advice that needed to be given. It's a serious problem, particularly when the plan fiduciary is not an expert in the particular area (that is why the fiduciary is, in fact, hiring the service provider in the first place). Fiduciaries need to know enough to ask the right questions and to enter into an agreement with the service provider where the scope of the engagement is appropriate. If the scope is too broad, the plan may overpay. On the other hand, if the scope is too narrow it may not accomplish the goal the fiduciary set out to accomplish by retaining the service provider in the first place.[52]

One such instance in which the scope of the engagement could be limited (in cases where ERISA does not apply) is by contractual terms which specify that the investment advice provided is discrete, where no ongoing compensation is received, and hence the investment advisor has no "duty to monitor"[53] the investments chosen.

III. The Standard of Care of an Investment Adviser

A. Is the Standard of Care for Investment Advisers Set Forth in the (Uniform) Prudent Investor Act?

What do individual clients come to the investment adviser for, with regard to investment advice? Generally, and unless otherwise agreed, clients possess a reasonable expectation that the investment adviser will design an investment strategy to match their goals. In most instances this means accumulating funds for retirement (or other specific needs), and/or providing for funds during retirement years. And this, in turn, most often means clients anticipate the investment strategy employed is "prudent."

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[52] U.S. Department of Labor, Employee Benefits Security Administration, "Report of the Working Group on Guidance in Selecting and Monitoring Service Providers" (November 13, 1996), available at http://www.dol.gov/ebsa/publications/srvpro.htm.

[53] Under state common law, a fiduciary must ascertain within a reasonable time whether an agent to whom he has delegated a trust power is properly carrying out his responsibilities. G. Bogert, Trusts and Trustees, § 557 at 155 (Revised 2d Ed. 1980). If a fiduciary is negligent in selecting, instructing or supervising an agent, he will be held liable to the trust beneficiary for any resulting loss. *Id.* at 156-57 *Contrast De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (Fed. 2nd Cir., 2002) ("[A] broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker's dutes ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer's investments … The giving of advice triggers no ongoing duty to do so.") *Id.* at 1302. ("[T]he giving of advice is an unexceptional feature of the broker-client relationship. What little case law there is on the subject makes clear that giving advice on particular occasions does not alter the character of the relationship by triggering an ongoing duty to advise in the future (or between transactions) or to monitor all data potentially relevant to a customer's investment.") *Id.* at 1307.

ERISA permits trustees of a plan to appoint an investment manager to manage plan assets. *See* 29 U.S.C. § 1102(c)(3). Where such an appointment has been properly made, the trustees are not liable for the acts or omissions of the investment manager. See 29 U.S.C. § 1105(d)(1). However, the appointment must occur of a person or firm who fits within the definition of "investment manager." *See Whitfield v. Cohen*, 682 F.Supp. 188 (S.D.N.Y., 1988) (investment management company which was not registered as an investment adviser, and which did not expressly accept fiduciary status, not an "investment manager" and hence delegation by plan trustee of investment authority to such investment management company did not accord plan trustee any relief from liability). Even then, however, a plan trustee possesses a duty to monitor. *Cf. Mehling v. New York Life Ins. Co.*, 163 F.Supp.2d 502 (E.D. Pa., 2001) ("implicit in New York Life's power to select the Plans' named fiduciaries is the duty to monitor the fiduciaries' actions, including their investment of Plan assets.")

At least in the view of one court, the standard of care for an investment adviser is the same standard of care that exists for a trustee managing the investments of a trust – *i.e.*, adherence to the Prudent Investor Act.[54] In a 1984 decision, applying state common law, the Superior Court of New Jersey stated:

> The obligation of the (professional investment adviser) to give prudent advice is the standard of care to be applied in this case. This is a higher standard of care than that found in the 'Know Your Customer' and 'Suitability' rules … The investment manager has an obligation to the customer to exercise prudence in diversifying investments in order to minimize the risk of large losses … The (defendants) owed plaintiff the duty to act with skill and care in accordance with industry practice, and to advise an investment strategy that, under the circumstances, was prudent … advice [must be] based on independent, objective analysis … Plaintiff … sought the expertise of a professional investment adviser because he was dissatisfied with his own ability to manage his investments. He was entitled to rely on defendants to give prudent advice to achieve his investment objectives.[55]

However, other courts have declined to adopt the "prudent investor act" standard for "investment managers."[56]

Regardless of whether your state has adopted the Prudent Investor Act as the standard of care for purposes of common law breach of fiduciary duty claims against investment advisers, it is likely that retail investors expect, of their investment adviser, that the portfolio which is managed for the client is to be managed "prudently" – absent an agreement between investment adviser and client to the contrary. Hence, investment advisers who undertake investment strategies and/or design portfolios for clients that would not be "prudent" – such as by managing a discrete portion of a client's portfolio, or accommodating a client's desire to assume much greater or lesser market risk (or other risks) than might be considered prudent – should likely seek the client's waiver of the Prudent Investor Act, in writing.

B. Not Every Investment Strategy Need Be "Prudent"

Even if one were to assume that the majority of individual investors, when aided by their investment adviser, expect a "prudent investment strategy" to be employed, this does not mean that every portfolio strategy employed by an investment adviser must conform to the diversification or other requirements of the Prudent

[54] "The Uniform Prudent Investor Act (UPIA) has fundamentally changed trust investment law in recognition of the alterations that have occurred in the field of investment management. They have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge and behavior of capital markets described as Modern Portfolio Theory. When and if the investment methods used by financial intermediaries - whether they are investment advisors, trustees, brokers or financial planners – are examined retrospectively, the standard to which their conduct will be held will be the UPIA. Therefore, it is important to understand the underpinnings of the UPIA even in non-trust settings such as traditional investment advisor and investment steward relationships. Lastly, it should be noted that the UPIA is a default standard and the individual relationships of fiduciaries can be altered contractually as the parties see fit. However, where the contractual terms are not clearly spelled out, the persuasive authority of the UPIA will most likely govern." Twin Focus Capital Partners LLC, Fiduciary Relationships & Duties in the Investment Context, arguing that "In a non-trustee setting, the UPIA can be viewed no in the view of statutory, or binding, authority but as persuasive authority." *Id.* at fn.25.

[55] *Erlich v. First Nat. Bank of Princeton*, 505 A.2d 220 (N.J.Super.L., 1984). *See also Johnson v. Johnson*, 515 A.2d 255, 212 N.J.Super. 368 (N.J. Super. Ch., 1986) ("If he had held himself out as a professional investment adviser, Seward would have been required to exercise "that degree of care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field.") (*citing Erlich*).

[56] *See, e.g., Nancie Hatheway v. U.S. Trust Company*, N.A., No. 33966-8-II (Wash. App. 1/17/2007) ("Washington has yet to adopt the "prudent investor" standard or any more specific fiduciary standard for investment managers" … We refuse … to extend [the prudent investor standard] to personal investment accounts.") *Id.*

Investor Act. The investment adviser and client can agree that a non-prudent, or speculative, strategy could be pursued.[57]

Indeed, the SEC's Form ADV Part 2 disclosures reflect the possibility an investment adviser and client might agree to deviate from a "prudent" investment strategy. A client may desire the investment adviser to adopt an overly aggressive or overly conservative asset allocation, which may not normally be considered prudent in light of the client's circumstances. Or a client may want the investment adviser to manage only a discrete portion of the client's assets, investing all of same in asset classes which, by themselves, would not be a prudent allocation for the client's overall portfolio. Or a client may want the investment adviser to engage in a speculative strategy, in hope of greater returns. In each of these instances the conduct is permitted, provided that all material facts pertaining to the strategy (including the material risks thereof) are affirmatively disclosed to the client, the investment adviser ensures the client understands those risks, and the client's informed consent is obtained (preferably in writing).

However, in each of these instances Form ADV Part 2A also requires that the investment adviser must provide additional discussion of the risks involved, in detail, if the investment strategy involves significant or unusual risks. Any investment strategy that may not be considered prudent would likely require such additional significant disclosures. In other words, the investment adviser's fiduciary duty may be constrained by the scope of the engagement, provided that any deviation from a prudent investment strategy is fully explained, understood, and agreed to by the client.

C. The Standard of Care is Relative

Even if the prudent investor rule is applied, against what benchmark is the investment adviser's "standard of due care" to be assessed?

> [Defendant] offered plaintiff professional investment advisory services …. It is therefore the degree of care, knowledge and skill expected of professional investment advisers to which we must look for the standard of care.[58]

In other words, you as an investment adviser are judged in your actions, not against the standard of care observed by individual investors, but rather against the higher due care expected of a professional investment adviser.

D. Is the Investment Adviser a Guarantor of Returns?

Does all this mean that an investment adviser's "prudent" investment strategy must always succeed? No, for as the *Erlich* court also stated:

> The investment manager is not a guarantor; he has no crystal ball with which to predict with perfect certainty the behavior of a particular stock in the market. When judging the actions of the manager with the benefit of hindsight, incorrect advice is easy to detect. We hasten to point out, however, that incorrect advice is not necessarily negligent advice….

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[57] As the *Erlich* court also stated, "[J]ust as a physician has a duty to obtain the informed consent of his patient for a course of treatment … an investment adviser deviating from the standard practice of diversification must inform his customer of the risks accompanying concentration of a portfolio in a few issues. The customer … must be in a position to make an informed choice of whether to follow the advice … If a customer's assets and cash reserves do not justify a … strategy but the customer nevertheless insists … the investment adviser, after informing the customer of the risks … should obtain the customer's express acknowledgement of the admonitions and his authorization to pursue this strategy. In essence, the customer would be expressly authorizing the investment adviser to give advice that, by objective standards, might amount to malpractice."

[58] *Devonshire v. Johnston Group First Advisors*, 300 F.Supp.2d 516 (N.D. Ohio, 2003) (citing Erlich).

E. But - You Must Be Able to Defend Your Investment Strategy

In a 2005 Pennsylvania case involving a trust and the application of the Prudent Investor Rule, the appellate court noted that the trustee must be able to "explain how an investment strategy was developed" and "why that strategy was prudent." As stated by the court:

> The trial court concluded that [the Trustee] through its own advertising, imposed upon itself a duty to make investment decisions in a manner consonant with the standard applicable to an expert possessing superior skill … A corporate trustee is required "to exercise a skill greater than that of an ordinary man" and its manner of handling investments must be evaluated "in light of such superior skill." *See Estate of Killey*, 457 Pa. at 477, 326 A.2d at 375 (*citing* Restatement (Second) of Trusts § 174 and explicating skill level to be exercised when a trustee holds itself out as being possessed of greater knowledge and skill than that of an average man); and *Estate of Scharlach*, 809 A.2d376, 384 (Pa. Super. 2002) (holding that a financial institution that specialized in fiduciary accounts is subject to a higher duty of care than is an ordinary person). As noted above, the Prudent Investor Rule does not alter the common law duty imposed on a fiduciary, but rather codifies the case law under the following rubric: "A fiduciary who represents that he has special investment skills shall exercise those skills." …
>
> *[O]ur legal standard … requires us to determine whether Trustee exercised its power in this regard prudently or whether it committed either negligence or gross negligence in developing and executing its investment strategy …*
>
> We do not evaluate a trustee's management of trust assets with 20/20 hindsight, nor do we require a trustee to be clairvoyant in selecting only optimal investments that always appreciate in value and never decline in worth. But even a trustee who must act with gross negligence before he can be held accountable, *must be able to explain how an investment strategy was developed for a specific trust and why that strategy was prudent under existing circumstances*. … In other words, a trustee must be able to demonstrate that the chosen investment strategy was not based on a conscious, voluntary act or omission taken in reckless disregard of the consequences to the trust.[59] [*Emphasis added.*]

Even though the court's decision was based upon the Prudent Investor Act's standard, which is not necessarily the standard to be applied to every portfolio advised upon by an investment adviser, nevertheless the principle exists that an investment adviser should be able to articulate and explain the rationale behind the investment strategy utilized.

F. Diversification, By Itself, is <u>Not</u> Enough to Meet the Standard of Due Care

While diversification is an important element of an investment strategy, at least in situations where the Prudent Investor Rule applies, merely undertaking diversification in an investment portfolio is not, in itself, a completely defensible investment strategy, as illustrated in this decision:

> Experts agree that diversification of assets is a wise approach to trust management. Our legislature has adopted that conclusion as the public policy of Pennsylvania … Nevertheless, the mode and methodology of a diversification strategy may be prudent, negligent, or grossly negligent, depending on the investments actually selected, the timing of asset sales or acquisitions, the goals of the trustor, and the factual circumstances surrounding the particular trust implicated by a specific diversification program.[60]

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[59] *In re Scheidmantel*, 868 A.2d 464, 486-7 (Pa. Super. Ct., 2005)

[60] *In re Scheidmantel,* 868 A.2d 464, 487 (Pa. Super. Ct., 2005)

G. Duties in Selecting Sub-Advisors or Managers

Implicit within the duty of due care there exists the responsibility of an investment adviser to act with prudence in selecting and supervising agents (investment managers, including but not limited to investment advisers to mutual funds and ETFs, etc.) to whom investment authority may be delegated.[61] "Generally, prudent delegation requires informed, careful planning and arrangements, including the procurement of the skill and time necessary to make a competent, careful evaluation of potential agents to whom duties are to be delegated, as well as continued supervision or monitoring of any such agents with respect to their performance and compliance with the terms of the delegation."[62]

In instances where ERISA applies, "[i]n evaluating whether a fiduciary acted prudently under ERISA, the court should inquire whether the fiduciaries 'at the time they engaged in the challenged transaction, employed the appropriate methods to investigate the merits of the investment and to structure the investment.'"[63]

IV. Is Your Investment Strategy Defensible? - The Battle of the Experts

A. The Courtroom (or Arbitration) Scenario: Who Proves What?

So what happens if the investment strategy used by the investment adviser fails, and the client sues?

An aggrieved client, to prevail in court proceedings or arbitration, must establish each of the following facts by a preponderance of the evidence. First, the client must prove that a "fiduciary" relationship existed between the parties (this is shown merely by citing the investment adviser's status as an investment adviser, in most instances). Second, that the investment adviser violated that fiduciary obligation by a specified act, or omission, which violated the investment adviser's fiduciary duties of due care, loyalty or utmost good faith. Third, that the client suffered damages as a proximate result of that violation of the fiduciary obligation.

To prove his or her case, the aggrieved client must submit credible evidence that the investment adviser engaged in an act or omission that violated the duty. This is normally done by expert witness testimony, on behalf of the plaintiff (typically the client of the fiduciary), which seeks to show that the investment adviser's investment strategy was imprudent.[64]

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[61] Rest. (Third) Trusts, §80(2), Duty with Respect to Delegation, and Res. (Third) Trusts, General Standard of Prudent Investment, §90(c)(2). *See also* Res. (Second) Agency, § 425, Agents to Make Investments, cmt a (instructing that the duties of an agent who has authority to make and manage investments are similar to those of the trustee of a formal trust, except in so far as they are affected by the fact that the principal has control and may modify or determine the investments at any time).

[62] Scott A. Meyers and James G. Martignon, The Post-Madoff Emergence of a Fiduciary Duty of Due Diligence – Recent Regulatory Enforcement Actions and Their Impact on Best Practices for Investment Managers, Practical Compliance & Risk Management for the Securities Industry (Sept.-Oct. 2009) *citing* Rest. (Third) Trusts, General Standard of Prudent Investment § 90, cmt j. and Rest. (Third) Trusts, Duty with Respect to Delegation, § 80, cmt d(2).

[63] *Ulico Cas. Co. v. Clover Capital Management, Inc.*, 217 F.Supp.2d 311 (N.D. N.Y., 2002).

[64] *Devonshire v. Johnston Group First Advisors*, 300 F.Supp.2d 516 (N.D. Ohio, 2003) "When a negligence claim involves professional skill or judgment, the plaintiff bears the burden of establishing the prevailing standard of care, the professional's deviation from that standard, and that the negligence was the proximate cause of the injury … Expert testimony is generally required to establish the standard of care in professional malpractice and negligence cases. Sturm v. Univ. of Cincinnati Med. Ctr., 137 Ohio App.3d 557, 562, 739 N.E.2d 364 (2000) (citing Berdyck, 66 Ohio St.3d at 578, 613 N.E.2d 1014). This is because "a person of superior knowledge and skill must employ that degree of care and skill that a person of the same learning and experience of ordinary care, skill, and diligence should employ in like circumstances." *Sturm*, 137 Ohio App.3d at 562, 739 N.E.2d 364. However, expert opinions are not required to establish the level of care and skill to be applied in situations where the conduct at issue is within the jury's general knowledge and experience. *Jones v. Hawkes Hosp. of Mt. Carmel*, 175 Ohio St. 503, 506-07, 196 N.E.2d 592 (1964); *Baiko v. Mays*, 140 Ohio App.3d 1, 7, 746

Once such "credible evidence" is shown by expert testimony offered by the plantiff, in most states the "burden of persuasion" will shift to the investment adviser to justify his or her actions or inaction.[65] This "burden of persuasion" refers to a "party's duty to convince the fact-finder to view the facts in a way that favors that party.

The fiduciary then has the burden to prove, by clear evidence, the fiduciary investment adviser's "compliance," or "non-breach," with his or her requisite degree of care. In such circumstances, quite literally the investment adviser is "presumed guilty" and must prove his or her innocence. In other words, the investment adviser must prove his or her "due diligence" was sound, with respect to the investment strategy.

Moreover, proof that "everyone was doing it" is insufficient. "[E]vidence of conformity to industry practice is not conclusive, and cannot set the standard of conduct … To borrow Justice Holmes' pithy formulation, what usually is done may be evidence of what ought to be done, but what ought to be done is fixed by a standard of reasonable prudence, whether it usually is complied with or not."[66]

N.E.2d 618 (2000) … The instant case likewise calls for a showing of the standard of care required of a reasonable professional investment advisor in defendant's situation. I therefore find that essential to plaintiff's claim of investment advisor negligence is the establishment of the standard of care through expert testimony.") *Id.* at 520-1.

Where negligent conduct is alleged in a context which is within the realm of common knowledge and everyday experience, the plaintiff is not required to adduce expert testimony either to establish the applicable standard of care or to prove that the defendant failed to adhere to it … Expert testimony is required, however, where the subject presented is 'so distinctly related to some science, profession or occupation as to be beyond the ken of the average layperson.' … The rationale for requiring expert testimony was well stated two-thirds of a century ago in a losing cause; courts should not leave it to 'a jury of tailors and haberdashers to pass judgment unaided by expert testimony on how to make a wet and rolling deck in a seaway a safe place to work.' *Beard v. Goodyear Tire & Rubber Co.*, 587 A.2d 195 (DC, 1991) (citations omitted). "[E]ven [when] the standard is ordinary business care and prudence, the field of finance is such that expert testimony is most helpful …." *Johnson v. Johnson*, 515 A.2d 255, 212 N.J.Super. 368, 391 (N.J. Super. Ch., 1986).

"Put more conceptually, proof of a common practice aids in formulating the general expectation of society as to how individuals will act in the course of their undertakings, and thus to guide the common sense or expert intuition of a jury or commission when called on to judge of particular conduct under particular circumstances." *Trimarco v. Klein*, 56 N.Y.2d 98, 107, 436 N.E.2d 502, 505, 451 N.Y.S.2d 52, 55 (1982) (quoting R. Pound, Administrative Application of Legal Standards, 44 ABA Rep. 445, 456-57).

[65] "[O]nce the ERISA plaintiff has proved a breach of fiduciary duty and a prima facie case of loss to the plan or ill-gotten profit to the fiduciary, the burden of persuasion shifts to the fiduciary to prove that the loss was not caused by, or his profit was not attributable to, the breach of duty." *Martin v. Fellen*, 965 F.2d 660, 671 (8th Cir. 1992). "(A)s between innocent beneficiaries and a defaulting fiduciary, the latter should bear the risk of uncertainty as to the consequences of its breach of duty." *Estate of Stetson*, 463 Pa. 64, 345 A.2d 679, 690 (1975).

[66] *Beard v. Goodyear Tire & Rubber Co.*, 587 A.2d 195, 199 (DC, 1991), *citing Texas & Pac. Ry. Co. v. Behymer*, 189 U.S. 468, 470, 23 S.Ct. 622, 623, 47 L.Ed. 905 (1903). "Much the better view, therefore, is that of the great majority of the cases, that every custom is not conclusive merely because it is a custom, that it must meet the challenge of `learned reason,' and be given only the evidentiary weight which the situation deserves. PROSSER & KEETON, THE LAW OF TORTS § 33, at 195 (1984)." *Beard* at 199.

B. But - Will the Investment Adviser's Expert Witness Be Permitted to Testify? – The *Daubert* and *Frye* Standards for Admissibility of Expert Testimony

The admission of expert testimony in federal court is governed by Federal Rule of Evidence Section 702.[67] Generally, if scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if: (1) the testimony is based upon sufficient facts or data; (2) the testimony is the product of reliable principles and methods; and (3) the witness has applied the principles and methods reliably to the facts of the case. In addition, expert testimony must be both relevant and reliable to be admitted. *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 589, 113 S. Ct. 2786 (1993). Similar standards of the admission of expert testimony exist in state courts (applying *Frye*[68] or *Daubert* standards for admission of expert testimony, or some combination of the rationale of these cases).

Under the *Daubert* standard, a judge or arbitrator makes a threshold determination regarding whether certain scientific knowledge would indeed assist the trier of fact (the jury, judge, or arbitration panel).[69] This entails a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid, as well as whether that reasoning or methodology properly can be applied to the facts in issue.[70] This preliminary assessment can turn on whether something has been tested, whether an idea has been subjected to scientific peer review or published in scientific journals, the rate of error involved in the technique, and even

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[67] Rule 702. Testimony by Experts. "If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case."

[68] Many states still adhere to the *Frye* test for the admissibility of expert testimony, and yet also apply exceptions to same. "Our test for the admissibility of expert testimony based on scientific knowledge has usually been the Frye test, "that is, whether the community of scientists involved generally accepts the theory or process. *Frye v. United States*, 293 F. 1013 (D.C.Cir. 1923)." . . . The test has a practical usefulness because, if there is general acceptance in the relevant scientific community, the prospects are high, but not certain, that the theory or process is reliable. The ultimate test, however, is the reliability of the theory or process underlying the expert's testimony... Thus we have recognized the risk that reliable evidence might be kept from the factfinder by strict adherence to the Frye test . . . Perhaps the relevant scientific community has not yet digested and approved the foundation of the theory or process, but the theory or process is so logically reliable that evidence should be admitted even without its general acceptance by involved scientists. In some circumstances, perhaps without adequately articulated reasons, we simply have decided that Frye principles do not apply in deciding on the admissibility of expert testimony apparently based on a scientific theory or process. *See* Geiger, The Judicial Gatekeeper: Should Massachusetts Apply *Daubert* to Screen Expert Testimony?, 79 Mass.L.Rev. 94, 98-99 (1994)." *Boston Partners Asset Management v. Archambo*, 19 Mass. L. Rptr. No. 1, 6 (MA 1/18/2005).

[69] "[T]he Rules the trial judge must ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable." *Daubert*, 509 U.S. at 589, 113 S.Ct. 2786. "Faced with a proffer of expert testimony, the trial court "`must determine at the outset pursuant to [Fed.R.Evid.] 104(a), whether the expert is proposing to testify to (1) scientific knowledge that (2) will assist the trier of fact to understand or determine a fact in issue.'"… In short, the trial court is to ensure that the testimony is both relevant (helpful to the trier of fact) and reliable (scientific validity) …." *Koch v. Koch Industries, Inc.*, 2 F.Supp.2d 1385, 1407(D. Kan., 1998).

[70] However, "*Daubert* does not require that a party who proffers expert testimony carry the burden of proving to the judge that the expert's assessment of the situation is correct. As long as an expert's scientific testimony rests upon good grounds, based on what is known, it should be tested by the adversary process—competing expert testimony and active cross-examination—rather than excluded from jurors' scrutiny for fear that they will not grasp its complexities or satisfactorily weigh its inadequacies. In short, *Daubert* neither requires nor empowers trial courts to determine which of several competing scientific theories has the best provenance. It demands only that the proponent of the evidence show that the expert's conclusion has been arrived at in a scientifically sound and methodologically reliable fashion." *Alco Industries, Inc. v. Wachovia Corporation,* 527 F.Supp.2d 399, 405 (E.D. Pa., 2007).

general acceptance, among other things.[71] It focuses on methodology and principles, not the ultimate conclusions generated.[72]

When expert testimony is accepted from two experts, with conflicting opinions, it is within the jury's (or other finders of fact) discretion to assess which testimony is most credible.[73]

In essence, if an investment adviser purports to utilize a "prudent" investment strategy, the investment adviser would be well-advised, to manage his or her fiduciary risk, to insure that the evidence developed by the investment adviser supportive of the investment adviser's adopted investment strategy will clear the same threshold analysis a court would employ as to whether expert testimony on the same point would be permitted. However, while the admissibility of expert testimony focuses on the methodology and not the results,[74] the investment adviser would be wise to focus on both methodology and results. In other words, not only will an investment adviser, if his or her investment strategy is later challenged, desire to ensure that expert testimony is available, but that the results of that expert analysis favor the investment strategy adopted.

Hence, an investment adviser may desire to seek answers to the following questions, when undertaking an analysis on any particular investment strategy:

1) Can the investment strategy be tested? In other words, are there one or more reliable scientific processes or techniques which may be utilized to assess the investment strategy?[75]

2) If so, then either:

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[71] "[W]hen the proffered expert relies on some principle or methodology," the trial court should consider a nonexhaustive list of nondispositive factors in determining whether the reasoning or methodology is scientifically valid or reliable: (1) Can it and has it been tested?; (2) Has it been subjected to peer review and publication?; (3) Does it have a known or potential rate of error?; and (4) Has it attained general acceptance in the relevant scientific community? *Compton v. Subaru of America, Inc.*, 82 F.3d 1513, 1518 (10th Cir.), *cert. denied*, ___ U.S. ___, 117 S.Ct. 611, 136 L.Ed.2d 536 (1996); see Summers, 132 F.3d at 603 n. 4). "The Supreme Court provided four non-exclusive factors to measure reliability …." *In re Enron Corp. Securities*, 529 F.Supp.2d 644 (S.D. Tex., 2006).

[72] The focus in evaluating these factors rests upon "the principles and methodology, not on the conclusions that they generate." *Daubert*, 509 U.S. at 595, 113 S.Ct. 2786. "But conclusions and methodology are not entirely distinct from one another. Trained experts commonly extrapolate from existing data. But nothing in either *Daubert* or the Federal Rules of Evidence requires a district court to admit opinion evidence which is connected to existing data only by the *ipse dixit* of the expert. A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered." *Koch v. Koch Industries, Inc.*, 2 F.Supp.2d 1385 (D. Kan., 1998). As part of the pretrial evaluation, the trial court also must determine whether the expert opinion is "based on facts that enable the expert to express a reasonably accurate conclusion as opposed to conjecture or speculation [but] absolute certainty is not required." *Kieffer v. Weston Land, Inc.*, 90 F.3d 1496, 1499 (10th Cir.1996) (*quoting Jones v. Otis Elevator Co.*, 861 F.2d 655, 662 (11th Cir.1988)).

[73] "Where the testimony of expert witnesses differ, it is the responsibility of the trier of fact to determine which evidence is the most credible. … Those credibility determinations are subject to the strictest deference and the manifest error-clearly wrong standard demands great deference for the trier of fact's findings. A fact-finder's choice between two permissible views of the evidence cannot be manifestly erroneous or clearly wrong. Thus, even if the testimony of both experts is considered credible, the trial court's choice of Asher's testimony over Boudreaux's cannot be found to be manifestly erroneous or clearly wrong, and cannot be disturbed on appeal." *Brown v. Schwegmann*, 958 So.2d 721 (La. App., 2007).

[74] "This inquiry focuses on the expert's principles and methodology, not his results." *In re Unisys Savings Plan Litigation*, 173 F.3d 145, 165 (C.A.3 (Pa.), 1992) (discussing examination of whether expert testimony should be admitted).

[75] "[I]n order to qualify as 'scientific knowledge,' an inference or assertion must be derived by the scientific method. Proposed testimony must be supported by appropriate validation--i.e., 'good grounds,' based on what is known. In short, the requirement that an expert's testimony pertain to 'scientific knowledge' establishes a standard of evidentiary reliability." *In re Unisys Savings Plan Litigation*, 173 F.3d 145, 165 (C.A.3 (Pa.), 1992).

a. Have published academic articles subjected the investment strategy to peer review, and what are the results of that peer review process? In other words, as a result of academic discourse, has the investment strategy gained general acceptance in the academic community?

b. Have you back-tested the investment strategy yourself? If so, was the back-testing methodology you utilized accepted in the industry? What is the rate of error seen in that testing methodology relatively low (and, as a result of achieving a low rate of error, did you ensure that "data mining" was unlikely to be present in your testing process)?

V. Applying the *Daubert* Standard – Applying Academic Scrutiny to Various Investment Strategies

Has your overall investment strategy, utilized for the benefit of your clients, been submitted to analysis involving back-testing over multiple time periods? Or, is your portfolio construction strategy based upon generally accepted academic research from multiple sources? If not, what will you do if called upon later to defend your investment strategy? Or should you disclose in your Form ADV Part 2A that your investment strategy either is not capable of being tested, or that it lacks academic support?

From this author's review of the academic literature, it appears that relatively few investment strategies, as to the design of portfolios for individual clients, withstand rigorous academic scrutiny. Some other investment strategies receive mixed reviews and remain the subject of continued discussion. The challenge for the investment adviser is to sift through the academic evidence, first by throwing out those studies which appear to possess an insufficient sample size, inappropriate benchmark, which rely upon data which suffers from survivorship bias, or in which the author appears to suffer from bias or potential bias. When this is done, what are the results of such a survey?

Following is the author's survey of some investment strategies commonly utilized today, and includes excerpts from recent academic evidence either supportive or not supportive of the strategy examined.

A. Momentum Strategies.

If transaction costs can be effectively controlled, momentum strategies in stock market investing (i.e., the tendency of securities that have outperformed the market over a short period of time to continue to outperform) possess relatively wide support in the academic literature. Moreover, momentum is one of the few effects that has withstood the test of time and does not appear to be captured by the Fama French factors. For an "Annotated Bibliography of Selected Momentum Research Papers" visit
http://www.aqrindex.com/AQR_Momentum_Indices/Momentum_Research/Content/default.fs.

B. The Small Cap and Value Effects, Generally.

Multifactor investing employing market capitalization (size) and valuation ratios (growth vs. value) reveal the "small cap effect" and "value effect," which again receive fairly widespread support in the academic literature over the past two decades, but provided that transaction costs are carefully controlled. These strategies are supported by numerous studies which back-test the strategies against highly evolved databases, often covering many decades and/or altogether different equities markets. More recently, research has revealed a possible fourth factor, pertinent to the possible exclusion of small cap growth stocks from a portfolio as a means of enhancing the portfolio's long-term returns.

Panopoulou et. al., Confirmation of Fama-French Factors. "[In a] series of papers by Fama and French (1993, 1995, 1996, FF henceforth) … the authors propose[d] a three-factor model, according to which the expected return on a portfolio in excess of the risk-free rate is explained by three factors; namely, the excess return on the market portfolio, the return on a portfolio long in small stocks and short in big stocks (SMB), and the return on a portfolio long in high-book-to-market stocks and short in low-book-to-market stocks (HML). SMB is often referred to as the size premium, while HML as the value premium … Consistent with previous findings, we confirm both the in-sample and out-of sample predictive ability of HML and SMB ….”[76]

Zhang, Modifying Fama-French 3-Factor Model to Add Fourth Factor: Small-Cap Growth. “Fama and French (1992) find that the size and book-to-market effects dominate all other firm-specific variables in explaining the cross-section of average returns, with average returns on small stocks higher than those on big stocks (the size effect) and average returns on high book-to-market stocks higher than those of low book-to-market stocks (the book-to-market effect) … This paper documents that the size and book-to-market effects have changed considerably since the publication of Fama and French (1992) published their paper … the original Fama-French three-factor model can no longer explain the much changed size and book-to-market effects well … This paper presents evidence that the small growth stocks are the main culprit of the much changed size and book-to-market effects that impaired the original Fama-French three-factor model.”[77]

Clark, Summarizing the Factors (2007). “Many studies document the existence of size and relative-price effects in equity markets in the US and many other countries. These findings have important implications for equity allocation. Investors may be able to increase the expected returns of their portfolios by holding small capitalization stocks and value stocks in greater than market-capitalizations proportions. Such portfolios are said to be ‘tilted’ toward small cap and value stocks.”[78]

C. Active Investment Management, Generally – Provable? Dangerous?

Many studies conclude that “active management” through security selection by investment managers, or by “tactical asset allocation” strategies (some form of market or sector timing) may add value, but on average that the added value does not cover the costs selected by the managers. Yet other studies and academics assert otherwise.

Judicial treatment of the Efficient Markets Hypothesis and passive and active management strategies varies. For example, as stated by one court fifteen years ago:

> Most academics in the field of finance advocate a combination of the random walk and the efficient market theories. Most Wall Street professionals, the security analysts and portfolio managers, disagree. The academics say that the stock market is self-regulating as it reacts to new information, and random selection of investments will follow the market. The most dramatic example was the Forbes index, composed of twenty stocks chosen by throwing darts at a list of securities on the stock exchange. Professor Thaler and others believe that profits can be made from cracks in the efficient market, and the relative strength theory is another gloss on the random walk-efficient market theories. It has been supported, as well as criticized, in the literature. *See* Robert A. Levy, "Random Walks: Reality or Myth," Financial Analysts Journal 69-77, (Nov.-Dec. 1967) and Frank C. Jen, "Discussion," Journal of Finance 495-499. (May 1970).[79]

Yet, for some purposes the Efficient Markets Hypothesis forms the basis for assessing not only damages, but also liability, as occurs in “fraud on the market” and “stock price drop” cases:

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[76] Panopoulou, Ekaterini and Plastira, Sotiria, Fama French Factors and US Stock Return Predictability (March 30, 2011). Available at SSRN: http://ssrn.com/abstract=1804927.

[77] Zhang, Chu, Decomposed Fama-French Factors for the Size and Book-to-Market Effects (December 1, 2008). Available at SSRN: http://ssrn.com/abstract=1345541.

[78] Clark, Truman A., The Dimensions of Stock Returns (August 2007).

[79] *Johnson v. Johnson*, 515 A.2d 255, 212 N.J.Super. 368, 392 (N.J. Super. Ch., 1986)

If there are no confounding factors in the disclosure or the market that would also cause a stock price drop, then causality is presumed by the efficient market hypothesis.[80]

Of course, "active investment management" refers to a wide variety of investment strategies, chief among them being some form of either selection of individual securities or the timing of markets or sectors.

In a sense, "active investment management" can never be "disproven," in the sense that there are so many individual strategies within active investment management, many relying upon qualitative judgments of portfolio managers (which therefore cannot be backtested). Also, new active portfolio management strategies, or variations thereof, arise all the time. Despite the diversity of active portfolio management strategies, in one recent case the plaintiffs attempted to present expert evidence that actively managed funds resulted in excessive fees and were imprudent selections for a plan governed by ERISA, and only a failure to plead the issue correctly apparently prevented the issue from being decided by the court.[81]

Following is a survey of two major aspects of active investment management – tactical asset allocation and portfolio manager selection - to ascertain what academic research has stated thus far:

1. Tactical Asset Allocation.

At best, mixed results are derived from studies on tactical asset allocation strategies, which employ some form of timing as to the equity markets (or sub-sets thereof) and/or fixed income markets to "rotate" to asset classes which are perceived to possess greater return potential relative to risks assumed. There are many different "tactical" strategies; I only highlight two, below.

Wang: Applying Value, Momentum and Mean-Reversion Can Generate Higher Returns Using ETFs. "We … examine whether we can improve on a given strategic asset allocation by tactically adjusting the weights of asset classes based on their perceived value and momentum attractiveness. The strategic asset allocation here is

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[80] *U.S. v. Schiff*, 538 F.Supp.2d 818 (D.N.J., 2008), *aff'd* 602 F.3d 152 (3rd Cir., 2010) ("The Third Circuit 'has one of the clearest commitments to the efficient market hypothesis.' *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 269 (3d Cir. 2005). In an efficient market, 'information important to reasonable investors (in effect, the market) is immediately incorporated into stock prices.'" *Id.*) Generally, event study methodology has its foundation in the efficient markets hypothesis. *See* Mark L. Mitchell & Jeffry M. Netter, The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission, 49 BUS.LAW. 545, 557 (1994). "[P]laintiffs who traded in an efficient market need not prove actual reliance on specific misrepresentations, but their counterparts who traded in an inefficient market must." *Basic v. Levinson*, 485 U.S. 224 (1988).

[81] *George v. Global* (7th Cir., April 11, 2011) ("Plaintiffs next argue that the district court abused its discretion when it struck plaintiffs' designation of Dr. Edward O'Neal as an expert witness on relevance grounds … Plaintiffs describe O'Neal as an expert on mutual funds and state that they sought to introduce his testimony in order to show that defendants paid excessive fees to the managers of the Growth Equity Fund and the Balanced Fund. Both of these funds were "actively managed," meaning that the manager of each fund attempted to beat the market through the selection of securities for inclusion in the fund. Active management can be contrasted with passive management—or indexing—in which fund managers simply replicate the performance of the market as measured by an index such as the S&P 500. Because active managers monitor, research and trade the holdings of the fund, they charge more for their services than passive managers.

One of the claims that plaintiffs sought to raise through their amended complaint was that the defendants imprudently allowed participants to invest their contributions in actively managed funds. Plaintiffs argued, and Dr. O'Neal opined, that active management is of dubious value, and that therefore the Plan should have offered only passively managed index funds to Plan participants. Because the district court denied the motion to amend, however, this claim did not become part of the case. Nonetheless, plaintiff still designated O'Neal as an expert, arguing that his opinion was relevant to the issue of whether the Plan paid excessive fees to the managers of the Growth Equity Fund and the Balanced Fund. Plaintiffs' theory was that because active management generally does not produce higher returns than passive management, any fee charged by an active manager in excess of the fee charged by a comparable passive manager would be excessive. The district court refused to allow plaintiffs to pursue this theory, finding that plaintiffs were attempting to sneak their claim regarding the prudence of actively managed funds back into the case.")

a representative mix of a broad and diversified seven (7) asset classes, including world equity, investment grade bond, high yield bond, cash, TIPS, commodity and real estate. For practitioners, our model provides a dynamic top-down approach to tactical asset allocation in accordance with the ever-changing market environments … we look at the value measurements, *i.e.* the Z-scores, to identify any asset class that is significantly under/over-valued and take advantage of the long-term mean-reversion mechanism … our model outperforms the top 25% in the pool in the long run using a return-only judgment … Using ETFs, our model on equal-weighted benchmark still put itself close to the top 25% in recent periods. Thus our model offers a low-cost and easily accessible way for individual investors to achieve institutional investor type returns, without the complication of hedge fund and private equity type managers that requires much more expertise and capital ….”[82]

2. Portfolio Manager Selection

Warren et. al. (2011): Institutional Investors Are Better in Picking Good Managers. “The efficacy of active investment management is an open issue. The majority of research focuses on U.S. equity mutual funds. It finds that while some active managers may possess skill, the majority of retail investors receive negative net alpha after fees (e.g. see Wermers (2000)). Analysis of institutional investors such as pension funds is more limited. The evidence suggests institutional investors fare better, and may even achieve positive net alpha, especially at the overall plan level (see Bauer et al (2010); Busse et al (2010)). Also influencing the debate over active management of active investment as a ‘zero-sum game’ (see Sharpe (1991)), implying that an investor can beat the market only at the expense of another who does not. It is possible for investors to choose active management, even when the aggregate performance of active managers does not justify their fees … investors are more likely to realize their alpha expectations if they have genuine capacity to identify good managers, appreciate the impact of fund size on alpha potential, and remain disciplined in adjusting managers in response to new information. Alternatively, investors are more likely to be disappointed if they are overly optimistic about their capacity to select good managers, unaware of how fund size erodes returns, and/or fail to utilize the option to dynamically adjust their portfolios ... the former has attributes that might be associated with institutional investors, while the latter appears more consistent with retail markets … This paper relates to a large literature that considers the efficacy of active management. Most of this research focuses on U.S. equity mutual funds. Notable recent papers include Wermers (2000), Kosowski et al (2006), Barras et al (2010) and Fama and French (2010). These authors suggest that the average U.S. equity mutual fund manager generates positive gross alpha prior fees in the order of +0.40% to +0.50%, but net alpha of about -0.50% to -0.60% after fees are deducted. Evidence exists of both skilled and unskilled managers in the tails of the distribution, although the strength of this evidence depends on the approach used.”[83]

Kang et. al. (2011): Alpha Not Easier in Small Cap and Emerging Markets. “It is worthwhile revisiting a few basics that are accepted by the proponents of active and passive management. First, when taking the market as a whole, active management is a zero-sum game, and a negative-sum game after transaction costs and fees. Secondly, it is notoriously difficult for managers to consistently deliver alpha on a risk-adjusted basis. Lastly, skillful active managers do exist, but institutional investors need to have the relevant skills and resources to identify such managers on a consistent basis. Thus, the decision to go active or passive often reflects cost considerations and resource constraints. However, there are other important dimensions. Institutional investors often rely on the relative efficiency of markets to gauge the level of opportunities for active management. For instance, emerging markets and the small cap segment are perceived to be relatively less efficient than developed markets and the large cap segment. Consequently, active management is generally thought to be more promising for emerging markets and small cap mandates … top US small cap managers have

[82] Wang, Peng, Applying Value and Momentum Across Asset Classes in a Quantitative Tactical Asset Allocation Framework (January 12, 2011). Available at SSRN: http://ssrn.com/abstract=1726443.

[83] Warren, Geoff J. and Foster, F. Douglas, Why Might Investors Choose Active Management? (February 22, 2011). Available at SSRN: http://ssrn.com/abstract=1767543.

not demonstrated stronger performance persistency than the top US large/mid cap managers. In fact, only about 7.1% of top quartile US small cap managers (compared with 9.6% of top quartile US large/mid cap managers) in the first period continued to rank in the top quartile over the following two periods, a probability that was close to random selection. A potential explanation for the lack of performance persistency is that the manager outperformance may be attributed to a combination of skill and luck. Urwin (2000) suggests that due to high noise-to-signal ratio in active manager returns, the performance may reflect the influence of chance more than the influence of investment skills. Fama and French (2010) use bootstrap simulations to study the role of luck versus skill in the cross-section of mutual fund returns, finding that some managers do have sufficient skill to cover costs, although such managers are few. Note that manager performance studies are often time-period dependent and subject to many potential biases, making further analysis over longer periods necessary to obtain more conclusive findings. Nevertheless, the empirical literature and our limited analysis suggest that there is no empirical evidence suggesting that perceivably less efficient markets may be associated with 'easier' alpha."[84]

D. Non-Diversified Portfolios: Disclose That Additional Risks Exist

The courts generally will permit evidence in of the added risks of investment portfolios which are not adequately diversified, as illustrated in this case:

> Dr. Cathy Niden, an economist whom Alco proposes as an expert witness, has prepared a report on whether the Alco plans' portfolios were diversified. She concluded that they were not. According to her report and deposition testimony, perfect diversification occurs when a portfolio eliminates all risk except so-called "market" or "compensated" risk. Niden Report, at 6. This view of diversification is well-accepted. See, e.g., Restatement (Third) of Trusts: Prudent Investor Rule § 227 cmt. g ("The ultimate goal of diversification would be to achieve a portfolio with only the rewarded or `market' element of risk."). Unfortunately, accordingto Niden, the perfectly diversified "market portfolio" exists only in the realm of theory. Niden Report, at 7. Therefore, to determine how diversified a given portfolio is, one can only compare it to a proxy for the market portfolio. Id. Here, Niden compared the Alco portfolios to the S & P 500, the S & P MidCap 400, and the Russell 2000, the benchmark indices specified in Alco's 1999 investment policy statement. Niden noted that the S. & P 500 was a particularly good proxy. Id. at 7-8. Through these comparisons, Niden calculated that up to 38 percent of the risk in the Alco portfolios was uncompensated (non-market) risk. Id. at 13. She further reported that this amount of uncompensated risk was both foreseeable in light of the investments and unreasonable. Id. at 9-11. She concluded that Wachovia could have reduced the uncompensated risk and added to the expected return significantly through additional diversification. Id. at 14.[85]

Investment advisers employing investment strategies which do not result in broad diversification among securities would be wise to disclose the extent of non-diversification and the resulting additional (uncompensated) risk assumed thereby.

E. Morningstar Star Ratings.

While the data set is relatively short since Morningstar changed its star-rating methodology in 2002, some recent studies have indicated that Morningstar star ratings may be predictive of outperformance, at least for five-star and four-star rated funds (on average) outperforming two-star and one-star rated funds. However, in the view of this author, additional research is needed. More testing is needed to ascertain if management, administrative, and 12b-1 fees, as well as transaction costs within funds, significantly affect the results. In other words, the research results to date, implying that five-star and four-star rated funds do, on average, possess

[84] Kang, Xiaowei, Nielsen, Frank and Fachinotti, Giacomo, Some Like it Hot (January 21, 2011). MSCI Barra Research Paper No. 2011-03. Available at SSRN: http://ssrn.com/abstract=1754027.

[85] Alco Industries, Inc. v. Wachovia Corporation, 527 F.Supp.2d 399, 405-6 (E.D. Pa., 2007).

higher future returns than lower-star-rated funds, may simply reflect the average higher costs incurred by many low-rated funds.

Antypas et. al (2009): Morningstar Star Ratings Possess Some Import. "This paper evaluates the Morningstar mutual fund ranking system. We find that indeed higher Morningstar ratings are associated with higher returns on the portfolios including respectively five-, four-, three-, two- and one-star funds only (STAR5 to STAR1). We then perform an unconditional and conditional portfolio performance evaluation. In both cases the evidence suggests that the better performance of the STAR3, STAR4 and STAR5 categories reflects superior stock selection rather than market timing abilities. Overall, the implication for the Morningstar ranking system is that this is most effective in identifying the worst-performing funds (STAR1 or STAR2) rather than the best-performing ones."[86]

If Morningstar star ratings are utilized, an investment adviser's Form ADV, Part 2A might contain the following disclosure: "Details about the methodology behind Morningstar's research ratings can be found by accessing the URL http://corporate.morningstar.com/US/html/pdf.htm?../documents/MethodologyDocuments/MethodologyPapers/MorningstarEquityResearch_Methodology.pdf."

F. Fund Fees and Costs – Due Diligence Requires their Assessment

"Most [mutual fund] investors are unaware of even the basics of their funds, do not take costs (especially ongoing costs) into account when they invest, and chase past fund performance, despite little evidence that past returns predict future returns. Fund investors who use financial advisers do no better."

- Professors Alan R. Palmiter and Ahmed E. Taha[87]

"Mutual fund costs are critical to analysis of the value of active portfolio management."

- Professors Chalmers, Edelen, and Kadlec[88]

The Need for Investment Advisers to Understand the Fees and Costs of Mutual Funds and Other Pooled Investment Vehicles. In the quotation above, Professors Palmiter and Taha paint a harsh picture of not only individual investors but also of "financial advisers" – which term they utilize broadly to include registered representatives of broker-dealer firms, registered investment adviser firms and their representatives, and/or financial planners. They further observed: "Fund investors also pay little attention to fund fees and expenses, particularly the regular costs that funds incur, such as management fees and trading costs … [a] survey indicates that financial advisers may make investors even less sensitive to loads, fees, and expenses than investors would be on their own … There is little evidence that financial advisers provide tangible benefits to fund investors or help them provide market discipline over mutual funds."

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[86] Antypas, Antonios, Caporale, Guglielmo Maria, Kourogenis, Nikolaos and Pittis, Nikitas, Selectivity, Market Timing and the Morningstar Star-Rating System (April 1, 2009). CESifo Working Paper Series No. 2580. Available at SSRN: http://ssrn.com/abstract=1360637.

[87] Alan R. Palmiter and Ahmed E. Taha, "Mutual Fund Investors: Divergent Profiles" SSRN Research Paper No. 1098991 (Feb. 2008); *see also* Daniel Bergstresser, John Chalmers, and Peter Tufano, "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry" (2007) ("We study broker-sold and direct-sold funds from 1996 to 2004, and fail to find that brokers deliver substantial tangible benefits. Relative to direct-sold funds, broker sold funds deliver lower risk-adjusted returns, even before subtracting distribution costs … We find that the brokered channel … does not show any evidence of superior aggregate market timing ability, and shows the same return-chasing behavior as observed among direct channel funds.")

[88] John M.R. Chalmers, Roger M. Edelen, and Gregory B. Kadlec, "Transaction-cost Expenditures and the Relative Performance of Mutual Funds" (1999) ("Our results confirm the negative relation found between expense ratios and fund returns and extend the conclusions drawn in indirect analyses of the relation between fund trading costs and fund returns ….")

Why do the professors offer such a harsh assessment of financial advisors? There are several reasons, but one that stands out is that many financial advisors are unaware of the total fees and costs of the mutual funds and other investment products they recommend. Or, perhaps they are aware, but erroneously believe they have no duty of duty diligence to discern the "hidden costs" of funds, nor disclose them to their clients and potential clients.

Yet, personal financial advisors are fiduciaries (by application of the Investment Advisers Act of 1940, similar state laws in nearly every state, and state common law), and their duty of due care carries with it a due diligence requirement. In the opinion of this author, this duty mandates an understanding of the characteristics of mutual funds when the financial adviser recommends their purchase to her or his clients. Since the "total fees and costs" of a mutual fund, ETF, or other pooled investment vehicle is certainly a material fact, the client should be informed of same, before being asked to consent to a purchase or sale transaction.

Why is determining "total fees and costs" so important*?* The net return an investor receives, whether investing in an index fund, an actively managed stock or bond fund, or directly in stocks, is not the gross return of the underlying securities, but the net return after transaction, or trading, costs are taken into account. The "annual expense ratio" is a poor indication of a fund's total fees.

Fees and Costs Matter. It is well known that, on average, mutual fund returns are negatively related to fund expense ratios.[89] Moreover, the presence of other fund costs – transaction and opportunity costs within the fund – also can lead to underperformance by stock mutual funds. While different academic studies debate the actual net impact of fees and costs, a substantial majority of the academic studies reveals that fees and costs, whatever form they take, negatively impact investors' returns. These academic conclusions run contrary to the understanding of many individual investors, who often assume that higher fund fees lead to improved performance.[90] In essence, the higher the fees and costs of a mutual fund, the lower its likely returns will be (on average) when compared to other similar mutual funds.[91] Moreover, it is not just the annual expense ratio

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[89] *See* Brad M. Barber, Terrance Odean, and Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows* (2003) (analyzing new money flowing into mutual funds from 1970 through 1999) ("Though there is no discernible relationship between performance and expenses for the majority of funds, investors clearly pay a large price for investing in funds with the highest expenses. These funds underperform by an economically large margin (26 to 37 basis points *per month*)." [*Emphasis in original.*]

[90] A Forbes Magazine survey found that eighty-four percent of the surveyed investors believed that higher fund expenses result in higher performance by the fund. Neil Weinberg, *Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs*, Forbes Magazine, Oct. 14, 2002, at 220.

[91] Mark Carhart finds that net returns are negatively correlated with expense levels, which are generally much higher for actively managed funds. Worse, Carhart finds that the more actively a mutual fund manager trades, the lower the fund's benchmark-adjusted net return to investors. Carhart, Mark, "On persistence in mutual fund performance," *Journal of Finance* 52, 57–82 (1997). A more recent paper also highlights the important of keeping costs low. "The more rigorous academic studies find that annual expense ratios generally detract from fund performance (see, for example, Elton, Gruber, Das and Hlavka (1993), Gruber (1996), and Carhart (1997)). On average, fund managers are unable to recoup the expenses that funds pay via better performance. Wermers (2000) finds that the underlying equity holdings of equity mutual funds do outperform the market, but that cash drag, annual expenses and transaction costs more than offset this outperformance. These findings suggest that basing fund investment decisions at least partially on fees is wise. Lower cost funds have a smaller drag on performance that active managers must overcome. Taken to their logical conclusion, these results may suggest that index funds, accompanied by the lowest expense ratios in the mutual fund industry, are a more logical long-run investment choice than more expensive actively-managed funds." Karceski, Livingston, and O'Neal, "Portfolio Transaction Costs at U.S. Equity Mutual Funds" (2004),
available at http://www.zeroalphagroup.com/news/Execution_CostsPaper_Nov_15_2004.pdf.

of a fund that matters; large portfolio transaction costs in a mutual fund can consume a large portion of the mutual fund's potential gross returns.[92]

This does not mean that personal financial advisors must always choose the lowest cost stock mutual fund for their clients. Rather, as fiduciaries, personal financial advisors must weigh the expected benefits which may result from a higher-cost investment product. For example, two mutual funds may hold very similar assets, but a higher-cost tax-managed version of the fund may result in a greater net return for the client when taxes are considered. Or a higher-cost fund may provide an investor's exposure to a different asset class (such as emerging markets) where the cost of operating the mutual fund may be generally greater.

"Total Fees and Costs" = "Disclosed Costs" + "Hidden Costs" – "Securities Lending Revenue" (+ "Tax Drag" for funds held in taxable accounts). Mutual funds and other pooled investment vehicles (such as exchange-traded funds, unit investment trusts, collective funds, and hedge funds) often possess extremely high total fees and costs. The "disclosed costs" of mutual funds, which is reflected in the annual expense ratio, is only one part of the total cost of the mutual fund. Other costs, including "hidden costs" and "tax impact" (or "tax drag"), can often be much higher than the "disclosed costs" of the mutual fund. Such fees and costs may be offset, often substantially, by securities lending revenue.

***What are the "Disclosed Costs" of Mutual Funds*?**

The Annual Expense Ratio. The annual expense ratio of a mutual fund is the total percentage of fund assets used each year for the following three types of expenses borne by fund shareholders:

management fees; plus

administrative fees; plus

distribution fees (12b-1 fees).

Front-End Sales Loads. The traditional load mutual fund ("A" shares) sold by stock brokerage firms imposes a commission up front, in which a lump sum is paid to the broker who sells the fund, with the balance invested.[93] The SEC does not limit the size of sales load a fund may charge, but FINRA does not permit mutual fund sales loads (front-end and back-end) to exceed 8.5% (including distribution fees such as 12b-1 fees).[94]

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[92] Professor Ian Domowitz considered the impact of mutual fund transaction costs and provided a hypothetical example of their impact. "Consider, for example, an equally weighted global portfolio of stocks. Over 1996:3 through 1998:3, one-way total trading costs for this portfolio average 71 basis points (bps). If the portfolio turns over twice a year, 285 bps in total costs are incurred. Average annual portfolio return over the period is 1228 bps. On this basis, trading costs alone account for 23 percent of returns." Domowitz, Ian, "Liquidity, Transaction Costs, and Reintermediation in Electronic Markets" (2001), available at http://www.smeal.psu.edu/ebrc/publications/res_papers/2001_04.pdf.

[93] A "sales load" is defined at "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer." IC Act, (§2(a)(35).

[94] NASD Rule 2320(d)(1)(A) provides that a fund without any asset-based distribution fees cannot charge aggregate front-end and deferred sales charges which exceed 8.5% of the offering price (and the rule limits the maximum aggregate sales charge to 6.25% for purchases over $25,000).

NASD Rule 2320(b) provides the following definitions:

(8) "Sales charge" and "sales charges," as used in paragraph (d), shall mean all charges or fees that are paid to finance sales or sales promotion expenses, including front-end, deferred and asset-based sales charges, excluding charges and fees for ministerial, recordkeeping or administrative activities and investment management fees. For purposes of this Rule, members may rely on the sales-related fees and charges disclosed in the prospectus of an investment company.

(A) An "asset-based sales charge" is a sales charge that is deducted from the net assets of an investment company and does not include a service fee.

As the dollar amount invested rises to fixed points, called "break points,"[95] the applied commission rates may fall.[96]

Deferred Contingent Sales Charges. Class B shares generally charge a "back-end" load for exiting a fund within 5 to 7 years of purchase. This fee is sometimes referred to as a contingent deferred sales charge (CDSC) or a "surrender charge." The back-end charge typically starts at 5% to 7% of the redeemed assets during the first year of purchase and declines by one percentage point each year until it reaches zero.

Since a broker must be compensated for selling the fund whether or not the investor redeems the mutual fund shares in the first several years, Class B shares often have higher annual expenses, including paying an ongoing 12b-1 fee.[97] In addition, break point discounts have been avoided by selling Class B shares. After the back-end load expires (5 to 7 years), the 12b-1 fee is no longer deducted from fund assets and the Class B shares convert to Class A shares. Brokerage sales practices involving Class B shares received substantial criticism in recent

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(B) A "deferred sales charge" is any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption.

(C) A "front-end sales charge" is a sales charge that is included in the public offering price of the shares of an investment company.

(9) "Service fees," as used in paragraph (d), shall mean payments by an investment company for personal service and/or the maintenance of shareholder accounts.

[95] Substantial fines have been levied upon broker-dealer firms for failing to provide break-point discounts which were provided for under the fund's prospectus. *See* NASD Notice to Members 02-85 (failure to give investors benefit of breakpoint discounts especially with respect to multiple accounts, rights of accumulation, letter of intent); *also see* cases dealing with failure to notify investors of the benefit of a breakpoint. A joint SEC/NASD/NYSE sweep found in 2003 that 1 in 3 eligible transactions did not get breakpoints. *See* Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003). A similar issue exists with variable annuity subaccounts and their NAV transfer programs (*see* AXA Advisors (February 26, 2004).

[96] Some mutual funds that charge front-end sales loads will charge lower sales loads for larger investments. For example, a fund might charge a 5% front-end sales load for investments up to $25,000, but charge a load of 4% for investments between $25,000 and $50,000 and 3% for investments exceeding $50,000. The investment levels required to obtain a reduced sales load are commonly referred to as "breakpoints." In the foregoing example the breakpoints were $25,000 and $50,000. Funds that offer breakpoints can set them at their discretion. The SEC does not require a fund to offer breakpoints in the fund's sales load. If breakpoints exist, however, the fund must disclose them. In addition, a brokerage firm that is a member of the NASD should not sell an individual investor shares of a fund in an amount that is "just below" the fund's sales load breakpoint simply to earn a higher commission. An individual investor may also be entitled to combine previous fund purchase amounts to obtain a breakpoint discount upon a purchase made today, or to obtain a breakpoint discount for an investment today if the investor agrees to make additional purchases in the future. In the latter case the individual investor would sign a "letter of intent" to make additional purchases in the future. Some mutual fund companies also aggregate fund purchases by related family members for purposes of breakpoints.

[97] We find that is often in the individual investor's interest to redeem a stock mutual fund which still possesses a contingent deferred sales charge, rather than keeping the fund until surrender charges disappear, for several reasons. First, the ongoing annual costs of the fund may be quite high relative to the costs of surrender and reinvestment in lower-cost securities. Second, the investment in the fund may not have been done tax-efficiently. Third, the fund may invest in securities in an undesirable asset class. Fourth, the fund may be subject to various risks to which the individual investor's portfolio should not be subjected (such as lack of adequate diversification, manager risk, and institutional risk). In essence, an investor should regard the contingent deferred sales charge as already having been paid (which, in most cases, it has - at least as to the brokerage firm which sold the fund), even though such charge is slowly and painfully extracted from the investor in the form of higher fees for the term of the surrender period. Each fund subject to a surrender fee requires an individual analysis, by the fee-only wealth manager, as to the appropriateness and timing of any surrender.

years and were the subject of substantial regulatory fines.[98] As a result, many funds or brokerage firms have discontinued the use or sale of Class B shares.[99]

The Two Major Components of the "Hidden Costs" of Mutual Funds: "Transaction Costs" and "Opportunity Costs." The "hidden costs" is used by this author to refer to all of the costs associated with holding a mutual fund other than sales loads, CDSCs, and those costs which are included in the fund's annual expense ratio (*i.e.*, management fees, administrative fees, and 12b-1 fees). I use the description "hidden" to describe these costs, given the lack of disclosure of these additional costs in the front part of the vast majority of funds' prospectuses (the part of the prospectus *some* investors might read) and given their complete non-disclosure in mutual fund fact sheets. While "hidden," these costs show up in determining the final performance returns for an investment vehicle.[100]

The "hidden costs" of mutual funds include several types of costs called "transaction costs,"[101] as well as "opportunity costs" an investor may incur due to cash holdings by the mutual fund. Transaction cost management has received increased scrutiny in recent years in connection with a mutual fund investment adviser's duty to achieve best execution.[102] Despite this effort, the "hidden costs" of stock mutual funds can often be quite high.

Portfolio Transaction Costs - "Direct Costs" and "Indirect Costs." Mutual fund portfolio "transaction costs" are the hidden costs which result from trading of securities (stocks, bonds, or futures contracts) by the mutual fund. They include "direct costs" (commissions, commission equivalents, mark-ups and markdowns, and taxes) and "indirect costs" (spreads, market impact costs, and opportunity costs due to delayed or canceled trades).

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[98] In 2005, the NASD fined six major firms - Citigroup Global Markets, American Express Financial Advisors (now known as Ameriprise Financial Services), Chase Investment Services, Merrill Lynch, Wells Fargo and Linsco/Private Ledger - a total of more than $40 million for unsuitable B share and C share sales. NASD ordered the firms to offer customer remediation on more than 400,000 mutual fund transactions made by more than 79,000 households, at a cost potentially greater than the amount of the fines. "NASD: 2005 in Review," PR Newswire, December 27, 2005.

[99] *See* IM 2830-1. *Also see* NASD Alert "Class B Mutual Fund Shares: Do They Make the Grade?" (June 25, 2003).

[100] The GIPS standards, available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2005.n5.4002, state: "2.A.5 All returns MUST be calculated after the deduction of the actual TRADING EXPENSES incurred during the period. Estimated TRADING EXPENSES are not permitted." GLOBAL INVESTMENT PERFORMANCE STANDARDS (2005-06), published by the CFA Institute.

[101] "Kissell (2006) discusses how proper assessment of trading costs requires an understanding of its components and how they influence trading. Nine cost components are defined in detail: brokerage commissions, trade taxes, trade fees, bid-ask spreads, delayed trade cost, price appreciation, market impact, timing risk, and opportunity cost. Of these, brokerage commissions and trade taxes are fixed costs and the remaining are variable costs. The only visible components are brokerage commissions, bid-ask spreads, and trade taxes." John A. Haslem, Chapter 17, "Normative Transparency of Mutual Fund Disclosure," p.40 (Nov. 22, 2008). Available at SSRN: http://ssrn.com/abstract=1105501.

[102] The TRADE MANAGEMENT GUIDELINES (2004) published by the CFA Institute state in pertinent part: "Investment professionals have a fiduciary duty to their clients to seek to achieve Best Execution for every trade … The concept of "Best Execution" is similar to that of "prudence" in intent and practice. Although prudence and Best Execution may be difficult to define or quantify, a general determination can be made as to whether they have been met. In making this determination, one would examine whether the assets were exposed to extraordinary hazards and whether the practice deviated from what other experts would commonly do. Prudence addresses the appropriateness of holding certain securities, while Best Execution addresses the appropriateness of the methods by which securities are acquired or disposed. Security selection seeks to add value to client portfolios by evaluating future prospects; Best Execution seeks to add value by reducing frictional trading costs. These two activities go hand in hand in achieving better investment performance and in meeting standards of prudent fiduciary behavior." *Id.*, pp.2,4.
Available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007.

How much trading of securities with stock mutual funds occurs? While some recent estimates place portfolio turnover in domestic stock mutual funds at 100% or greater,[103] a study by the Investment Company Institute (a mutual fund trade organization) reports asset-weighted average annual turnover rate for U.S. stock mutual funds as only 51% in 2004 (which is a decline from a 73% turnover in 2001).[104]

What are the "Direct Costs"? Whenever an individual investor buys or sells stocks, he or she pays a commission to a broker. This is also true for institutional investors, such as mutual funds, as they often have to have a commission too (although it is usually less than what an individual pays). Commissions are fees directly paid by a mutual fund to a broker-dealer for executing a trade, including the processes of accepting and routing the order and clearing the trade. Other direct costs could be indirectly paid for executing a transaction, such as principal markups and markdowns, commission equivalents, or other fees. Markups and markdowns occur when a broker-dealer sells a stock or other security to a mutual fund out of its inventory, or when a broker-dealer purchases a stock or other security from a mutual fund to add to its inventory.[105]

Stock Funds and ETFs – Brokerage Commissions Relating to Trading of Securities within the Fund. While commissions and certain commission equivalents should be discernable by a stock mutual fund and inclusively reported, at times a mutual fund may be unaware of whether a transaction was executed on a principal basis (in which case the cost is disclosed by the broker-dealer to the fund) or a riskless principal basis (in which case the true cost of the trade may not be known to the fund).[106] Nevertheless, the amount of brokerage commissions paid by a fund (not including principal mark-ups and mark-downs, which relate mostly to bond trading) which are disclosed in the stock mutual fund's Statement of Additional Information can be utilized as an indication of a stock mutual fund's commission costs for brokerage services.

"Commission Recapture." One way to seek to minimize brokerage commissions is through "commission recapture." Commission recapture seeks to "unbundle" commissions from total execution costs, returning a portion of the commission directly back to the mutual fund, thereby conserving assets, lowering expenses and increasing investment returns. When a portion of the brokerage commissions are returned directly to the fund (and not to the investment adviser for the fund, instead; see discussion of soft dollar arrangements, below), this

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[103] "[B]etween 1950 and 1965, it was a rare year when fund portfolio turnover much exceeded 16%, meaning that the average fund held its average stock for an average of about six years. But turnover then rose steadily and surely and fund managers now turn their portfolios over at an astonishing average annual rate of 110% ...." John Bogle, "The Mutual Fund Industry in 2003: Back to the Future," Remarks by John C. Bogle, Founder and Former Chairman, The Vanguard Group, before the Harvard Club of Boston, January 14, 2003.

[104] Investment Company Institute® *Research Commentary*, "Mutual Funds and Portfolio Turnover," November 17, 2004, available at www.ici.org.

[105] For some regulatory purposes, such as soft dollar disclosures, the SEC has interpreted the term "commission" to include commission equivalents and other forms of remuneration in certain types of "riskless principal" trades. A "riskless principal" transaction is a "transaction in which a member [broker-dealer], after having received an order to buy a security, purchases the security as principal at the same price to satisfy the order to buy or, after having received an order to sell, sells the security as principal at the same price to satisfy the order to sell." NASD Rule 4632(d)(3)(B). "Traditional" riskless principal transactions can include an undisclosed fee (reflecting a dealer's profit on the difference in price between the first and second legs of the transaction) and are not subject to the disclosure requirements of NASD Rules 4632, 4642 or 6420. With the decimalization of stock prices, broker-dealers are trading on a riskless principal basis more frequently than when stock prices were fractionalized. As a result, commission equivalents are an increasingly large component of mutual fund transaction costs. *Report of the Mutual Fund Task Force Soft Dollars and Portfolio Transaction Costs*, NASD, November 11, 2004. Although riskless principal trades might appear to be relatively easy to quantify, the true cost of these trades (excluding commissions) reflects the extent to which closing prices might move due to the executing broker's actions. Measuring what might have occurred in the absence of a trade is subject to varying estimates.

[106] *Report of the Mutual Fund Task Force Soft Dollars and Portfolio Transaction Costs*, NASD, November 11, 2004.

can reduce the overall level of brokerage commissions paid by the fund and add to fund shareholder returns slightly.

"Soft Dollars": Higher Brokerage Commissions Paid for "Research." The level of commissions paid for the same trades can vary widely from one mutual fund to another. This is because many mutual funds shift certain operational costs from the disclosed management fees to the hidden transaction fees.[107] This occurs under a practice known as "soft dollars," under which a mutual fund permits higher commissions to be paid in return for research services.

The use of client commissions to pay for research services presents the mutual fund's manager with a significant conflict of interest, and may give incentives for mutual funds to disregard their best execution obligations when directing orders to different brokers. In fact, in a recent survey of funds, researchers noted: "Funds are required to report in their [SEC] filing whether the sale of fund shares; the receipt of research; or commission rebates are a consideration in choosing brokers … Consistent with agency-motivated trading from soft dollar relations, we find that an affirmative answer to each of the three soft-dollar questions is associated with elevated trading volume."[108]

The SEC is not permitted to outlaw soft dollar arrangements. In 1975 the U.S. Congress enacted Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") to provide a safe harbor that protects mutual fund managers from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive "brokerage and research services" provided by a broker-dealer - if the managers determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received. While the SEC recently narrowed the types of services eligible for soft dollar payments,[109] higher commissions for trades are still paid by many mutual funds. A recent positive development, from the standpoint of mutual fund investors, has been a trend toward the "unbundling" of trade execution and research purchases.[110]

The Prohibition on "Directed Brokerage." Directed brokerage is prohibited. A mutual fund may not compensate a brokerage firm for the sale of shares by directing to the brokerage firm portfolio securities transactions. Additionally, a mutual fund may not direct transactions to a brokerage firm that promotes or sells its shares *unless* it has adopted policies and procedures reasonably designed to prevent: (1) the person responsible for selecting brokers to consider such sales activity; and (2) the entering into of any agreement

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[107] A mutual fund company that pays for its own research (either through internal staff or by payments to third party research firms) "must bear the cost from its own capital and charge a management fee that makes the cost explicit to investors. Consequently, a fund has an incentive to outsource services in a manner that keeps the cost unobservable to investors. This is accomplished through the trading process. Institutions can legally fund the most basic aspects of their operations out of client assets by paying higher trading commissions, and receiving non-trade related services from the intermediary as a form of 'rebate.'" Robert A. Schwartz and Benn Steil, *Controlling Institutional Trading Costs*, JOURNAL OF PORTFOLIO MANAGEMENT (Spring 2002).

[108] Roger M. Edelen, Richard Evans, and Gregory B. Kadlec, *Scale effects in mutual fund performance: The role of trading costs* (March 17, 2007 version) (utilizing a sample of 1706 U.S. equity funds during the period 1995-2005).

[109] SEC Release No. 34-52635, *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934* (October 18, 2005).

[110] ITG "Investor Overview" presentation, December 2005. Some firms may be foregoing soft dollars in the future. "Fidelity Investments struck a deal with Lehman Brothers recently to pay for Lehman's research with its own hard-earned cash rather than that of its millions of small investors. It is pursuing similar deals with other brokers. As part of its campaign, Fidelity has also publicly egged on its many competitors to do the same and use commissions strictly for executions. Fidelity's move to decouple its payments for research from those for executions was not a complete surprise to those in the trading industry. The buyside gorilla had declared its willingness to unbundle in a letter to the SEC just last year ... 'I think there is a very good chance that the rest of the industry will follow Fidelity's lead,' said Ken Worthington, a securities industry analyst with CIBC World Markets." Gregory Bresiger, "Unbundling Looms," *Traders Magazine* (January 2006).

under which the mutual fund directs portfolio securities transactions to a brokerage firm in consideration for the sale of shares. Despite the enactment of this rule, violations of these principles have recently occurred, and a cursory review of mutual funds' Statements of Additional Information reveal that funds which are sold mainly through brokerage firms still direct a large portion of their trades through those firms.

Brokerage Commission Costs Pay for Execution Costs. The revenue a brokerage firm generates from brokerage commissions does not all stay with the broker-dealer firm. Broker-dealer firms possess several forms of costs relating to trade execution:

> The general overhead required to operate a trading desk and clear a trade;
>
> Market execution costs, on the exchange, which vary by exchange. There are numerous exchanges, including the well-known New York Stock Exchange (NYSE), Amex, and Nasdaq, but also a variety of Electronic Communications Networks (ECNs). All of them generally impose a small per share market execution fee;
>
> Market routing costs, which are incurred in some exchanges (NYSE, Amex, and Nasdaq); and
>
> Trading fees imposed by the SEC and/or FINRA.

Since these are the costs of a brokerage firm, not (generally) the institutional trader (i.e., mutual fund or ETF), these specific fees and costs are not further explored in this white paper.

Brokerage Commission Rates Vary by Market (Country). Commission rates also vary by market (*i.e.,* by country). For example, agency commissions on equity trades in the UK and Japan average a relatively modest 13 basis points, but agency costs skyrocket in emerging markets such as Korea (33 basis points) and Poland (50 basis points).[111]

What are "Indirect Costs"? While total direct costs are relatively easy to quantify, indirect portfolio transaction costs, including bid-ask spreads, market impact costs, and opportunity costs (due to delayed or canceled trades), are far more difficult to measure.[112] In fact, industry participants who are responsible for analyzing these costs

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[111] Proszek, Stan, "Transition Management: Simple - But Not Easy," *Benefits and Pensions Monitor* (October 2002).

[112] "The disclosure [of transaction costs] must not only ... measure the cost of conventional limit and market orders, but also of volume-weighted-average-price (VWAP) orders, market-on-close (MOC) orders, basket trading, stop-loss orders and other modern methods of portfolio management, including orders that are hedged in the options or futures markets and orders that arbitrage between equities and derivatives markets ... For many securities (notably many international equities and both US and foreign debt securities), there simply is no continuous two-sided firm-quote data available about the relevant securities. Most if not all of the proposed methods of quantifying spread costs, market impact costs, and opportunity costs are useless if there is no continuous quotation data (or if the available quote data consists merely of non-firm 'invitations to deal' that are often far from actual transaction prices). For many order types, such as VWAP or market-on-close trades (or stop orders), the concepts of trade decision time and trade execution time at best are difficult to apply. Even in the US equities markets, there is rarely reliable, firm depth-of-book quote data available beyond a thin National Best Bid or Offer (NBBO) which is virtually irrelevant to institutional-sized orders ... In short, there is no 'silver bullet' that will allow an easy quantification of transaction costs in a way that would be comparable among all the different types mutual funds. If the Commission were going to go down that path, it would have to develop and constantly modify specific rules for every possible asset class (Argentine high-yield corporate debt, Slovakian sovereign debt, Turkish equities, Chinese/Hong Kong dual-listed securities, etc.) and, within each market, for each order type. ... Even where the data is most available (for example, the market for US large-cap equities), different experts will assess differently the costs of an order ... In sum, transaction cost measurement is an art, not a science - and pretending that it is a quantifiable science would mislead investors, not enlighten them. A whole industry exists in the US to assist institutional investors in measuring transaction costs, and no two players in this industry come up with the same answers ... Just because transaction costs are difficult to measure does not mean they do not have a real and important impact on investors - they do ...." Comments of W. Hardy Callcott, former Assistant General Counsel for Market Regulation, dated January 30, 2004, to the SEC's "Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs," available at

for their firms disagree about which measure is most accurate for the various costs.[113] Spread, impact, and opportunity costs, sometimes collectively called "implicit costs," can often greatly exceed the explicit commission costs resulting from trading securities.

Bid-ask spreads. Bid-ask spreads are the difference between the bid and the ask prices for a security at a given time, where the ask price is the highest price anyone wants to pay for the security at a given time, and the bid price is the lowest price anyone wants to sell the security for at a given time. The simplest way to convince yourself that this spread is a cost is to consider the following scenario: you buy a stock, then turn around and sell it immediately. Since these transactions are simultaneous, the actual price of the stock is presumed constant, but you still lose the spread on the transaction.

Market Impact Costs. Market impact costs result from the effect of a large trade triggering a move in the price of the stock to the moment of trading from the price that would have prevailed had the trade not occurred. When a mutual fund buys a large quantity of shares, the mutual fund has to pay a price higher than the market price at the time of the purchase. Thus, the mutual fund is said to "move the market," as its trade has an impact on the market prices. Obviously "large" is a relative term. For a stock on the Nasdaq exchange that does not trade very often, an order to buy a few thousand shares is "large," while for a stock like General Electric an order to buy a million shares is "large." Due to the adverse effect of market impact, institutional investors tend to spread their orders over a few days or even weeks, breaking their trades up into smaller packets. Nevertheless, market impact costs still result.[114]

Costs of Delayed or Canceled Trades. Opportunity costs due to delayed or canceled trades refers to the effect of "not owning what you want to own." In trading terms, this type of opportunity cost is the net result (positive or negative) of price movements that occur when execution is delayed. The longer a portfolio transition (i.e., the sale of one security, and the purchase of another) takes, the higher the cost. As time passes, at some point the rising opportunity cost more than offsets the benefits from reduced market impact.

Taxes and Exchange Costs. Taxes and exchange fees can mean extra non-negotiable costs, depending on the market. For example, stamp duties add another 50 basis points to United Kingdom share purchases. We do not address these costs in this working paper, as we concentrate on U.S. stock mutual funds.

Can Portfolio Turnover be utilized to (Easily) Estimate "Hidden Costs"? While portfolio turnover has often been utilized by advisors as a means to estimate trading costs within funds, the use of this statistic, alone, is a poor one. First, portfolio turnover, if based upon SEC methodology, may significantly understate the true trading volume. Second, portfolio trading costs vary by wide amounts depending upon the market cap of the stock traded and the average trade size.

Opportunity Costs due to Cash Holdings. Equity mutual funds hold cash for several purposes. First, funds hold cash to meet shareholders' redemption needs. One of the defining features of open-ended mutual funds is that

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http://www.sec.gov/rules/concept/s72903/whcallcott013004.htm.

[113] "[T]here is no generally agreed-upon method to calculate securities transaction costs." SEC Rel. No. IC-26313 (Dec. 18, 2003), 68 Fed. Reg. 74819 (Dec. 24, 2003). Moreover, mutual fund transaction costs vary from one mutual fund company to another. The Plexus Group reports many of the best mutual fund companies have pursued trade cost-reduction programs to the benefit of the investors, often reducing total transaction costs by up to 40% over a two-year period. Testimony of Wayne H. Wagner, Chairman, Plexus Group, before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (March 12, 2003), available at http://financialservices.house.gov/media/pdf/031203ww.pdf.

[114] "Large institutional orders are sensitive to market depth for at least two reasons. First, filling a large order may take several days and multiple transactions; hence a large order likely suffers price concessions as market depth is consumed. Second, information leakage may move prices adversely as the institutional investor attempts to fill the order." Bollen, Busse, *Tick Size, Trading Costs, and Mutual Fund Performance*, fn. 8 (2004).

they are required by law to redeem shares on a daily basis. If investors redeem their fund shares in droves, funds without enough cash on hand have to sell stocks (or borrow cash) to meet these redemptions. Therefore, the primary benefit of holding cash in a mutual fund is to reduce trading costs.

Cash may also be accumulated to pay management fees and other expenses and to make dividend and capital gain distributions. In addition, cash may be accumulated as a result of market timing activities (i.e., an expected drop in prices) or due to fund management delay in identifying appropriate opportunities for investment. Unit investment trusts are not permitted to reinvest stock dividends received during a quarter, as unit trusts accrue cash dividends for the stocks in the trust and pay dividends (less trust expenses) on a calendar quarter basis; this can lead to another means of cash accumulation in certain types of stock mutual funds and certain forms of exchange-traded funds.

In addition, cash holdings to an investor result from dividend and capital gain distributions. Mutual funds go "x-dividend" on a certain date, but the cash is not actually paid to the investor until a later time - days or weeks later. The extended time for payment of dividend and capital gain distributions can even cross calendar years, as occurred during 2005-6 with Vanguard's VIPERS, Barclay's iShares, and other exchange-traded funds.

The primary "cost" of a mutual fund which holds cash (or a dividend or capital gain distribution being undertaken but not yet available for reinvestment) is the opportunity cost inherent in not being invested in stocks or bonds, as the mutual fund's strategy dictates. Wermers (2000) estimated that cash and bond holdings lower the performance of an average equity fund by 70 basis points per year over the period from 1975 to 1994.

Securities Lending Revenue. In securities lending transactions, securities held within investment portfolios are frequently lent to parties willing to pay to borrow them. These transactions, sometimes called repurchase agreements (repos), loans and sell-buyback arrangements, are generically described as securities lending, and represent a potentially significant source of revenue for many mutual funds and ETFs.[115]

Summary – Due Diligence on Pooled Investment Vehicles – Fees and Costs.

"Educated investors know that past investment returns are not necessarily the best predictors of future results. It's mutual fund and other expenses that really matter. Morningstar, in an act of radical and admirable transparency, recently put that assertion to the test and found that expenses actually helped investors make better decisions than its own vaunted star-rating system."[116]

In fact, using expense ratios as a guide to choose the best mutual funds were more helpful than star ratings 58 percent of the time. Given the substantial impact "hidden" fees and costs possess on investor's returns, as well as "tax drag" for funds held in taxable accounts, the diligent investment adviser to a retail client would, as part of his or her due diligence process, seek to quantify such fees and costs and/or tax drag.

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[115] The business of securities lending was recently generally described by Craig Karmin in his article, "Securities Lending is Getting Squeezed (*Wall Street Journal*, Oct. 1, 2008): "The business of securities lending can seem yet another obscure corner of Wall Street. But it is big business for funds with huge portfolios of stocks. The profits earned from securities lending are one reason why index fund companies like Vanguard can charge clients such small fees. They can also boost overall pension-fund returns. Under a typical agreement, a pension fund lends out securities and receives cash as collateral, plus another 2%. That cash is then handed over to a broker, who invests the money so that the pension fund can get an additional return on that collateral of as much as 1% per transaction.

[116] Tara Siegel Bernard, "Fund Expenses More Important Than 5-Star Status" (New York Times, Aug. 11, 2010), available at http://bucks.blogs.nytimes.com/2010/08/11/fund-expenses-more-important-than-five-star-status/?src=busln.

G. Hedge Fund Due Diligence, Generally

A recent case, when discussing the admissibility of expert testimony, illustrates the proper expertise required and potential greater scope of inquiry required when undertaking hedge fund due diligence:

> Beloreshki is an experienced economist with undergraduate and graduate degrees in economics from the University of Chicago. Nevertheless, Plaintiffs raise three concerns with Beloreshki's qualifications—none of which are sufficient to exclude his testimony. First, Plaintiffs argue that Beloreshki lacks training and experience in some necessary aspects of hedge fund due diligence. According to Plaintiffs, hedge fund due diligence can be divided into two categories—quantitative analysis (e.g., valuing a hedge fund's financial portfolio) and qualitative analysis (e.g., evaluating a hedge fund's key personnel). While Plaintiffs agree that Beloreshki has significant experience with the quantitative analysis of financial instruments and portfolios, they argue that he lacks sufficient experience with relevant aspects of qualitative analysis. Plaintiffs are correct that Beloreshki has less experience with the qualitative aspects of hedge fund analysis than he has with the quantitative aspects. However, during his more than a decade-long career in the financial sector, Beloreshki has worked on multiple projects that incorporated the qualitative analysis of hedge funds. Given Beloreshki's in-depth knowledge of quantitative portfolio analysis, this general experience with qualitative analysis is sufficient to qualify him to educate the jury about the steps that an investor should take before investing in a hedge fund.[117]

In discussing one expert's testimony, the court also alluded to steps an investment adviser could undertake in undertaking due diligence on a hedge fund:

> In his expert report, Weiser provides guidelines for analyzing the adequacy of investor due diligence. Specifically, he asserts that the process of conducting due diligence includes four steps: (1) "Oral communications with the manager to assess the manager's background, investment acumen and strategy, and the fund's performance"; (2) "Review of relevant documents including PPMs, investment newsletters, and marketing materials produced by the manager describing the manager's investment program as well as information produced by third parties, such as audited financial statements and performance reports"; (3) "Discussions with other investors, service providers and others with the ability to provide a reference on the integrity and capabilities of the investment manager and confirm the reported performance of the fund"; and (4) "The presence of quality service providers upon whom the investor could rely."[118]

H. In Search of (Other) Anomolies: Your Investment Strategy and Form ADV Part 2A Disclosures.

What about other strategies which also don't (yet) survive the rigor of academic scrutiny? While the Efficient Markets Hypothesis has been generally accepted (in one of its several forms) by many academics (as well as in some judicial decisions), the recent occurrence of market bubbles and developments in behavioral finance have challenged the notion that all markets are 'efficient' (at least perfectly so).

Indeed, some evidence exists that capital markets display micro-structures that a careful investor might be able to take advantage of. Yet an understanding of the risks assumed during such attempts to take advantage of perceived anomalies remains nascent. Additionally, in today's constantly evolving financial markets, elements of risk often become increasingly interdependent. Hence, attempts to take advantage of mispricing anomalies can easily run afoul of the legal principles underlying the Prudent Investor Act, as well as generally accepted

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[117] *Univ. Of Montreal Pension Plan V. Banc Of Am. Sec.*, 691 F. Supp.2d 448, 460-1 (S.D.N.Y., 2010).

[118] *Univ. Of Montreal Pension Plan*, 691 F. Supp.2d at 465).

concepts in financial theory, which provide only one answer to the question of when an undiversified portfolio bears too much risk -"always."[119]

Moreover, the "efficient frontier" employed by adherents to Modern Portfolio Theory often substantially moves over time due to changing risk premiums and related economic conditions. Science constantly sorts through new data in an attempt to discern those factors which drive returns. Science also constantly seeks out better ways to discern and measure various forms of risks.

In this dynamic environment, the challenge for today's investment adviser is to seek to identify those investment strategies which offer significant probabilities of outperforming appropriate benchmarks, net of fees. In addition, tax considerations should be taken into account where appropriate. Also, investment advisers should adequately ascertain and disclose all of the material risks of the investment strategies so identified. This is particularly so when the investment strategies adopted by the investment adviser have not received intense academic scrutiny.

This is not to imply that investment advisers might not engage in efforts to improve portfolio performance through individual security selection or by means of tactical asset allocation (or picking investment managers who do either of the foregoing). Nor does this imply that investment advisers should ignore Morningstar star ratings (or other similar rating services), or that investment advisers should not seek to identify and employ better investment strategies.

Rather, when investment strategies are employed in the investment portfolio, the investment adviser must judge whether – by expert testimony which is admissible under the *Daubert* or *Frye* standards – such investment strategies would be deemed "prudent." If the conclusion cannot be reached that such strategies are prudent (and that an expert would be permitted to testify as to such, due to the presence of substantial academic support for the investment strategy utilized), then much greater disclosures to clients must be undertaken of the risks of the strategies in Form ADV Part 2. Such disclosures could be repeated or elaborated upon in other documents provided to clients, such as the Investment Policy Statement.

In other words, speculative or novel or new investment strategies may be employed by an investment adviser. Also, an investment adviser may utilize strategies which are based purely upon the investment adviser's qualitative judgments (using a macroeconomic or "top-down" approach, or a "bottom up" approach, or any other approach). However, in such instances the fiduciary adviser must fully disclose the all of the material risks of such strategy utilization, in a manner designed to secure the client's full understanding of such risks.

The SEC's Form ADV Part 2 disclosures – of investment strategies and their risks – should cause all investment advisers to re-visit their "due diligence" – and to re-evaluate the risks that need to be disclosed. As the SEC's Instructions state, "If the method of analysis or strategy involves significant or unusual risks, discuss these risks in detail …."

Your degree of disclosure varies depending upon the investment strategy you utilize. If you do not possess sound academic research or adequate statistical back-testing supportive of the overall investment strategy you utilize for your clients, your investment strategy will likely require substantial Form ADV Part 2 disclosures as to the many risks you are requesting your clients to assume.

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[119] In the context of the law applicable to trustees, "Diversification is a uniformly recognized characteristic of prudent investment and, in the absence of specific authorization to do otherwise, a trustee's lack of diversification would constitute a breach of its fiduciary obligations. *See* Restatement (Third) of Trusts Sec. 229(d); *See also Erlich v. First Nat. Bank of Princeton*, 208 N.J.Super. 264, 505 A.2d 220, 236 (Ct.Law Div.1984) (An investment manager has an obligation to exercise prudence in diversifying investments to reduce the risk of large losses; indeed, diversification has been the accepted practice since "the early case of *Dickinson's Appeal*, 152 Mass. 184, 25 N.E. 99 (1890*)."")." Robertson v. Central Jersey Bank & Trust Co.*, 47 F.3d 1268, 1280 at footnote 4 (C.A.3 (N.J.), 1995).

Moreover, investment advisers can expect increased scrutiny of their due diligence practices during examinations by both federal and state securities regulators. Due diligence as to overall investment strategy, in the design of portfolios for clients, should be carefully documented. As always – say what you do, and do what you say – in the disclosures and other literature delivered to your clients.

In the appendices that follow are some sample disclosures under Item 8 of Form ADV, which may serve to assist you in fashioning (or enhancing) your Form ADV Part 2A disclosures.

Thank you.

END OF DISCUSSION.

APPENDICES ATTACHED.

APPENDIX A – FORM ADV, PART 2A SAMPLE INVESTMENT STRATEGY AND RISK OF LOSS DISCLOSURES FOR A FEE-ONLY RIA EMBRACING PASSIVE INVESTMENT MANAGEMENT

Item 8: Methods of Analysis, Investment Strategies and Risk of Loss

Generally

(RIA Firm) provides an investment strategy and its implementation for most clients. Clients of (RIA Firm) receive the benefit of our investment philosophies, strategies, due diligence, account monitoring, and certain personal financial planning recommendations.

(RIA Firm)'s Investment Committee establishes the overall investment strategies employed by the firm, reviews the brokerage firms we recommend to our clients, and approves of particular investments which may be used by advisors of our firm. The Investment Committee includes (names).

Expansive academic research, investment information, and certain proprietary analyses are drawn upon in order to provide innovative and comprehensive wealth management and investment advisory services. Each client receives a written Investment Policy Statement, which sets forth a recommended strategic asset allocation which we believe is appropriate for each client's situation and investment time horizon(s). In our view, most individual investors possess not a single investment time horizon, as to when funds are to be withdrawn from the investment portfolio, but a series of investment time horizons, as the client's investment portfolio finances a present and/or future stream of consumption. Our recommended strategic asset allocation seeks to take these varying time horizons into account.

Strategic asset allocation is based on Modern Portfolio Theory, in that an asset allocation is determined among selected asset classes based on each client's personal long term risk and asset return expectations and/or needs. Such an allocation is called strategic as it is meant to be long term oriented and should be only adjusted when some major events occur, such as a job change, or periodically (such as attaining various ages).

Behavioral finance economists have documented various psychological biases investors possess which can negate the ability of an individual investor to adhere to a strategic asset allocation during times of strong market advances or declines. It is essential that clients are able to withstand declines in the value of the overall investment portfolio, which declines we believe are largely unpredictable. Moreover, clients should be prepared to accept our recommendations to rebalance their portfolios during such times, without knowing whether a "market bottom" has been reached, in order to reap some of the benefits of our strategic asset allocation strategy. Also, changing the portfolio allocation mix during market bottoms to a more conservative strategic asset allocation can result in long term damage to the likely achievement of the client's financial goals. At the same time, clients should also be prepared to accept our recommendations to rebalance their portfolios during strong market price advances, in effect "taking gains off the table," never knowing if a "market top" has been reached or if even stronger market price advances await. We believe one of the ways we add value to our clients is by applying our insights and wisdom to facilitate such a disciplined approach to rebalancing, as we seek to counter various behavioral biases investors possess which frequently result, without the aid of a financial advisor, in the investor "selling low" and "buying high."

However, at times a change in a client's strategic asset allocation may be recommended. Changes in the client's strategic asset allocation will likely result in transactions in a client portfolio, and these transactions could have tax consequences for a client account and result in additional transaction fees incurred by the client.

To implement a client's strategic asset allocation, specific no-load (no commissions or sales loads) (and also no 12b-1 fees) investments are then recommended to clients, based upon the due diligence which is undertaken by our Investment Committee. Clients' portfolios are then periodically monitored, and changes to investment portfolios are suggested when appropriate. A disciplined approach to rebalancing is recommended to the clients in order to maintain asset class exposures within desired risk tolerances, subject to variances permitted for tax planning or other reasons. Clients may either provide, or withhold, discretion for the investment advisor to undertake trades on clients' accounts.

Methods of Analyses and Investment Strategies, Generally

In designing investment plans for clients, (RIA Firm) relies upon the information supplied by the client and the client's other professional advisors. Such information may pertain to the client's financial situation, estate planning, tax planning, risk management planning, short-term and long-term lifetime financial goals and objectives, investment time horizon, and perceived current tolerance for risk. This information becomes the basis for a strategic asset allocation which we believe will best meet the client's stated long-term personal financial goals. The strategic asset allocation, incorporates those asset classes which (RIA Firm) believes (based upon historical data and our own proprietary analysis) will possess attractive combinations of return, risk, and correlation over the long term.

A tremendous amount of academic research reveals that strategic asset allocation is determinative of the majority of the expected long-term gross returns of investor's portfolios. Our selection of asset classes is driven by research into global asset classes by such academics as Professor Eugene Fama, Sr. of the University Of Chicago Booth Graduate School Of Business and the Center for Research in Security Prices, Professor Kenneth French of Dartmouth College, and many other academics and researchers.

The investment advice which (RIA Firm) provides is based upon long-term investment strategies which incorporate the principles of Modern Portfolio Theory. The utilization of several different asset classes as part of an investor's portfolio is emphasized, as this has been shown to usually effect a reduction in portfolio volatility (i.e., the standard deviation of the portfolio returns) over long periods of time. (RIA Firm) allocates and diversifies the client's assets among various asset classes and then among individual investments, following the investment policy agreed to by the client.

(RIA Firm)'s investment approach is firmly rooted in the belief that markets are fairly efficient (although not always rational) and that investors' gross returns are determined principally by asset allocation decisions. A focus is provided on developing and implementing globally diversified portfolios, principally through the use of low-cost and tax-efficient passively managed stock mutual funds that are generally available only to institutional investors and clients of advisers granted access to such funds, as well as through fixed income investments and mutual funds holding publicly traded REITs.

Investment policy and overall portfolio weightings as between equities and fixed income investments are based upon each client's needs and desires, perceived risk tolerance and the need to assume various risks, and investment time horizon. The portfolios of clients may then follow models designed by (RIA Firm) to fit the overall weightings of equities (stocks, stock mutual funds, etc.), REITs, and fixed income investments (notes, bonds, bond funds, CDs, etc.) in an investor's portfolio. For other clients, the investment portfolio's strategic asset class allocation is customized to meet the specific circumstances of a client, the presence of investments in 401(k) or other accounts, as well as a perception of the client's understanding of the fundamental forces affecting risk and return in the capital markets.

In addition, a client's initial or revised strategic asset allocation may be influenced by a review of the relative valuation levels of various asset classes and the investment time horizon of that client. While asset class "bubbles" are attempted to be discerned when they occur, and if discerned may warrant changes to a client's asset allocation, tactical asset allocation strategies are not generally employed in connection with the management of client portfolios.

Methods of Analysis: Sources of Information

Our security analysis methods include fundamental, quantitative and economic analyses. Our research is based upon a number of factors, including factors and other information derived from commercially available software technology, securities rating services, general economic and market and financial information, due diligence reviews, and specific investment analyses that clients may request. The main sources of information include commercially available investment information and evaluation services, financial newspapers and journals, academic white papers, and other periodicals. Issuer-prepared information (including prospectuses, statements of additional information, and annual and other reports filed with government agencies), and data aggregation services (Morningstar Advisor, etc.) are also utilized. Investment Committee members and advisors also attend various investment and financial planning conferences.

Research is also received from consultants, including financial economists affiliated with Dimensional Fund Advisors (DFA) and other firms. DFA provides historical market analysis, risk/return analysis, and continuing education services. Various computer software programs from DFA and from other third parties may also be utilized to better model the historical and/or expected returns of designed portfolios. The historical valuation levels of various asset classes (as measured by p/b, p/e, p/c, and/or p/s data for various stock indexes) are also utilized by (RIA Firm) to undertake estimates of the probable long-term (15-year) expected returns of various asset classes, as a means of aiding investment and financial planning decision-making.

Types of Investments

Each client typically receives an investment portfolio which consists mainly of no-load stock and bond mutual funds. The passively managed stock funds offered by Dimensional Fund Advisors (DFA) are generally recommended. DFA mutual funds offer broad diversification and most are structured for low turnover, so as to substantially lessen the often substantial transaction costs incurred by most mutual funds and ETFs as they trade securities within the fund. Consequently, DFA stock mutual funds' total fees and costs are believed to be generally lower than the total fees and expenses incurred by most other stock mutual funds (including many ETFs and index funds) when comparing funds in the same asset class(es).

Many investment portfolios also include individual fixed income investments (bonds, CDs, etc.) and/or bond funds (primarily from DFA and Vanguard). For clients with a substantial fixed income allocation, (RIA Firm) generally recommends a combination of bond funds and individual fixed income investments, with recommended actual investments dependent upon (RIA Firm)'s views of the risk/return relationship for various forms of fixed income investments or bond funds. (RIA Firm) will typically request discretionary authority from clients to manage individual fixed income assets, as such may be necessary to enable the investment adviser to purchase or sell such assets in a timely manner at quoted prices. For clients with $8,000,000 or greater in total assets under advisement, (RIA Firm) will generally offer customized fixed income portfolios. All individual fixed income securities recommended will be investment-grade at the time of recommendation. For clients with less than $8,000,000 of assets under advisement, low cost bond mutual funds are generally utilized for amounts allocated to fixed income securities.

Client portfolios may also include some individual equity securities, but these are generally part of clients' investment holdings prior to becoming a client of (RIA Firm). However, clients with significant amounts to devote to investing in equities ($15 million or greater, generally) may also participate in a separate account program, which includes individual stocks using a highly diversified approach. This separate account program utilizes Dimensional Fund Advisors as the separate account manager, and may employ individual stocks as well as the use of Dimensional's mutual funds for some foreign stock or other asset class exposures.

Publicly traded real estate investment trusts (REITs) and commodities index or passive mutual funds or ETFs may be recommended for certain clients who desire to include real estate or commodities in their asset allocation strategy.

Insurance products such as annuities and various types of life insurance products may also be evaluated. Recommendations may be undertaken to clients to invest in low-cost, no-load (no commission) variable or fixed deferred or immediate annuities when appropriate to the circumstances and tax situation of the client. More often, this occurs when a client possesses an existing high-cost variable annuity, and a rollover of the annuity is indicated rather than redemption for tax planning purposes, in order to seek to lower the total fees and costs paid by the client and/or provide different investment choices. At times, clients may be advised to retain an existing annuity, previously purchased by the client, or undertake partial or full surrenders of same (and/or tax-free exchanges), following an evaluation of the annuity contract, riders thereto, investment alternatives within the annuity and their fees and costs, and any surrender fees which may be imposed by the insurance company.

New clients' existing investments are evaluated in light of the desired investment policy objectives. We work with new clients to develop a plan to transition from a client's existing portfolio to the desired portfolio. Investment advice may be offered on any investments held by a client at the start of the advisory relationship. At the initiation of our relationship, or thereafter, we may recommend the sale of existing securities, which may result in long-term or short-term capital gains, the realization of ordinary income, or other tax consequences; you are responsible for all tax liabilities arising from such transactions, as well as all other tax liabilities resulting from any other transactions in your account from time to time.

Each client's portfolio holdings and strategic asset allocation are then monitored periodically, taking into account the cash flow needs of the client. Review meetings with clients are held regarding their investment assets under advisement and other personal financial planning issues. Should tax-lot sales be undertaken, to harvest capital losses, you understand that the performance of your investments may be adversely affected, especially if your account(s) possess higher-than-normal cash positions for any period of time. You also realize that new taxable gains or losses could be generated if similar securities are purchased and then sold during such tax loss harvesting process.

Risk of Loss, Generally

Investing in securities involves a risk of loss that clients should be prepared to bear. However, the strategic asset allocation investment methodology utilized, combined with small-cap and value tilting, will still subject the client to declines in the value of their portfolios, which can at times be dramatic.

Our investment recommendations seek to limit risk through broad global diversification in equities (through broadly diversified stock mutual funds and/or separate account management programs) and investment in high quality fixed income securities or diversified bond funds. However, the correlation of asset classes varies across economic cycles and as the global economy becomes more integrated. For example, recent academic research has suggested that more positive correlations result as between equities and bonds at the peak of market cycles. Accordingly, the benefits of diversification among multiple asset classes may not, in the future, or at times, be as great as they have been in recent years or in the past.

We believe there exists a high probability in most market environments of a long-term (15-year or greater) outperformance of small cap and value stocks, relative to large cap and growth stocks, and hence the stock (equities) portion of an investor's portfolio may be "tilted" toward small cap and value stocks. Accordingly, the normally greater expected returns of the equity portion of the portfolio will in turn often permit the overall allocation to equities (stocks, stock mutual funds) to be reduced, and the allocation to fixed income investments increased. (RIA Firm) believes this is the best manner to temper the shorter-term volatility of the stock market, especially for clients who derive cash flow from their portfolios (such as clients who are in retirement years). Even then, however, our strategic asset allocation investment methodology results in varying risks and expected returns over time, due not only to variations in economic or market cycles but also due to changes in the valuation levels of various asset classes.

Given the long-term nature of the expected equity premium (i.e., the additional expected return for investing in the overall stock market, relative to less "risky" U.S. Treasury bills), and the long-term nature of the expected value and small cap effects, (RIA Firm)'s investment philosophy is best suited for investors who desire a buy and hold strategy for a substantial portion of their funds. (RIA Firm)'s stock mutual fund (or separate account manager) strategies are usually appropriate for clients possessing an investment time horizon of a minimum of ten years, and preferably even longer. Even then, investing is inherently uncertain as to future returns. While both macroeconomic and microeconomic risks are evaluated, for purposes of weighing risks and returns and for the computation of the expected returns of various asset classes (for use in financial planning decision-making), (RIA Firm) does not generally engage in market-timing activities. (RIA Firm) believes the equity, value and small cap effects are highly likely to occur in the future, over long periods of time. However, there can be no assurance that these effects will occur over any given time period, nor that the investment strategy will perform better than or equal to the performance results of any benchmark or index used in connection with a client's investment portfolio. While (RIA Firm) seeks to reduce non-compensated risks to which a client may be exposed, other risks (including but not limited to market risk, i.e., the risk of a general stock market or bond market valuation level decline) may be assumed in order to seek to attain the client's longer-term financial goals and objectives. However, (RIA Firm) cannot provide any guarantee that the client's goals and objectives will be achieved.

All mutual funds, ETFs, and other investments have certain risks that are borne by the investor. However, as with all investments, clients face investment risks in our investment programs, which may include (but are not limited to) the following: Loss of Principal Risk, Market Risk, Value Investment Risk, Small Company Risk, Tax-Management Strategy Risk, Social Investment Risk (for socially responsible investment funds), Environmental Impact

Consideration Investment Risk (for funds limited as to choice of investment due to environmental impact considerations), risks arising from the use of derivatives within the fund (derivative securities are subject to a number of risks including liquidity, interest rate, market, credit and management risks), Securities Lending Risk, Foreign Securities Risk, Interest Risk, Income Risk, Call Risk, Inflation Risk (and, where applicable, Inflation-Protected Securities Interest Rate Risk), Reinvestment Risk, Business Risk, Credit Risk, Risks of Banking Concentration, Risks of Investing for Inflation Protection, Liquidity Risk, Manager Risk, Global and Country/Regional Economic and Political Risks (including but not limited to the risks of terrorist attacks and war), Currency Risk, Specific Company and Sector Risks (for those of our clients who chose to retain as part of their portfolios individual equity securities previously acquired), and Financial Risk. For a more detailed description of these risks, and to determine which risks are applicable to the specific mutual funds and ETFs we recommend as part of your investment portfolio, please refer to each fund's summary or statutory prospectus, which may be obtained either online at each investment company's web site or upon request to our firm; you should read the prospectus and other disclosure documents, as applicable, for each investment selection recommended to you and/or held as part of your investment portfolio. As a result of the presence of these different types of risks, and others which may not have yet been predicted, adverse events may occur; there can be no assurance that the investment strategies employed in a client's portfolio will be profitable.

Risk of Loss, Certain Higher-Risk Securities

Certain securities recommended, such as U.S. small cap value and mid cap value stock mutual funds, U.S. small cap and microcap mutual funds, and similar pooled investment vehicles inside variable annuities, possess higher levels of volatility (as individual asset classes within a portfolio). Credit risk for high-yield bond funds is relatively higher than for other bond funds, as such bond funds invest mainly in bonds and loans with medium- and lower-range credit quality ratings.

(RIA Firm) may employ these higher risk securities as part of an overall strategic asset allocation for a client, and when such is undertaken, (RIA Firm) possesses a reasonable belief that the risk-return relationship for these securities, within the context of the overall portfolio, will likely be beneficial for the investor over the long term.

Please also note that while all Certificates of Deposit (CDs) purchased for our clients are FDIC-insurance, the pricing of certain of these CDs, which trade in the secondary market, can vary; accordingly, due to price declines and/or transaction costs associated with trading, these CDs could lose value if redeemed prior to maturity. When CDs are recommended to clients, it is our intent that clients hold the CDs to maturity.

Cash Balances in Client Accounts

Cash in clients' investment accounts are typically swept into the bank or money market mutual fund accounts of the institutions (TD AMERITRADE INSTITUTIONAL or FIDELITY INVESTMENTS INSTITUTIONAL SERVICES). (RIA Firm) discusses with each client, during the time of review conferences and at other times, upcoming cash flow needs and seeks to plan accordingly to meet those needs. While it is not the practice to encourage clients to maintain a large amount of cash in their accounts, such may be undertaken at the request of the client, to facilitate billing of (RIA Firm)'s periodic fees or for other reasons. Upon request of a client, cash balances will be maintained for temporary or short-term purposes.

Should the client desire a "cash reserve account," (RIA Firm) will assist the client to establish a separate, non-managed cash reserve account, which is not monitored thereafter by (RIA Firm), typically either with Vanguard (using one of its money market funds) or with an online bank (offering FDIC-insured money market funds, up to certain limits). (RIA Firm) then seeks to review with the client, during periodic conferences, whether any funds are needed to restore cash reserves. (RIA Firm) excludes separate accounts established for cash reserve purposes in the calculation of (RIA Firm)'s assets under advisement, and hence excludes the value of cash reserve accounts from a client's fee calculations.

EXHIBIT B – INVESTMENT STRATEGY DISCLOSURE FOR RIA FIRM UNDERTAKING BASIC STRATEGIC ASSET ALLOCATION WITH A MIX OF PASSIVE AND ACTIVE INVESTMENTS

Methods of Analysis

Security analysis methods at (FIRM) include fundamental analysis. The main sources of information include Morningstar reports, fund prospectuses, S&P reports, Argus reports, Thompson Reuters Stock Reports, financial newspapers and magazines, research materials prepared by others, filings with the Securities and Exchange Commission, and annual reports. Employees of (FIRM) also attend on- and off-site visits with fund and portfolio managers, conference calls, and industry conferences.

Investment Strategies

The primary investment strategy we use for client accounts is strategic asset allocation. We may use passively managed index and exchange-traded funds when appropriate for the client and actively managed funds, dividend paying stocks, and individual municipal bonds where there are opportunities to make a difference by security selection. Portfolios are generally globally diversified to control the risk associated with traditional markets. We may also at times recommend unrelated, third party investment managers who have a greater expertise in certain disciplines when appropriate for the client.

The investment strategy for a specific client is based upon the objectives, income needs, and tax situation stated by the client during consultations. The client may change these objectives at any time. The client's goals and objectives are recorded during meetings and via correspondence with the client. Each client portfolio is constructed solely for that client. We do not use model portfolios, and we do not utilize composites to illustrate results.

> *Question: Would prospective clients understand what "strategic asset allocation" is all about? And what risks might be present with same – including the risk that clients will not rebalance during periods of market exuberance or substantial market declines?*

Risk of Loss

All investment programs have certain risks that are borne by the investor. Our investment approach keeps the risk of loss in mind. However, as with all investments, clients face investment risks including the following: Loss of Principal Risk, Interest-rate Risk, Market Risk, Inflation Risk, Currency Risk, Reinvestment Risk, Business Risk, Liquidity Risk, and Financial Risk.

> *Question: Are all of the principal risks which might be contained in the prospectuses for the chosen funds listed here? Should there be a reference made to each fund's prospectus for a further description of this catalogue of risks?*

EXHIBIT C – ITEM 8 DISCLOSURES FOR MULTI-STRATEGY, ACTIVE INVESTMENT MANAGEMENT

Item 8: Methods of Analysis, Investment Strategies and Risk of Loss

Methods of Analysis

(FIRM)'s methods of analysis include a combination of top-down macroeconomic research and bottom-up fundamental research. We continually evaluate domestic and global economies and markets, and our evaluation is shared with clients in our quarterly newsletter. This written analysis of economic and financial issues provides the framework for asset allocation decisions in client portfolios and in our Diversifier investment strategy. Our macro analysis also informs our fundamental, bottom-up security selection process and sector weightings in our All Cap Value, Growth and Value Blend, and Fixed Income strategies.

(FIRM) uses multiple sources of information in our analyses, including our proprietary screening criteria; online subscription data services, such as Thomson ONE and Baseline; corporate annual reports, prospectuses, filings with the SEC; inspections of corporate activities; third-party research; corporate ratings services; newspapers and financial periodicals.

Risk of Loss

Investing involves a risk of loss that clients should be prepared to bear. Securities can lose some or all of their value and in a difficult market can become somewhat illiquid, depending on company-specific, economic, market, and political conditions. Clients bear the risk that (FIRM) may invest in securities that underperform a particular benchmark.

> *Is this risk of loss disclosure sufficient – i.e., that securities involving active managers may underperform a particular benchmark? Given that academic research suggests that most active managers of stock equity funds underperform their benchmarks, net of fees, should such a fact be disclosed? Should the risk that the RIA firm and/or its advisors may not be effective in selecting active managers which outperform, over time, index funds, be disclosed?*

Investment Strategies and Material Risks

All Cap Value Investment Strategy

The All Cap Value equity strategy seeks stocks offering the best values across a broad range of market capitalizations, from $200 million to over $50 billion. We seek companies whose shares trade at a significant discount to our estimate of intrinsic value and companies which have strong cash flows and an identifiable catalyst to unlock the value we discern. Our investment horizon is ordinarily 3-5 years. We seek purchases at medium to deep discounts to private market value. We hold so long as intrinsic value rises faster than the share price, and we sell when we believe the share price and the business value have converged. The All Cap Value equity strategy is benchmarked for performance comparison to the Lipper Multi-Cap Value Index, which is a peer index of managers utilizing comparable strategies. We additionally benchmark our All Cap Value to the Russell 3000 Value Index because of the more detailed characteristics available for this Index.

Material Risks - The All Cap Value strategy invests primarily in equity securities, which may decline in value due to fluctuations in the overall stock market or due to issuer or industry specific factors. The strategy may invest in companies that are based or have operations outside the U.S. and can lose value due to political, social, economic or currency changes. The strategy may invest in small and midsize companies, and securities of these companies are sometimes more volatile and less liquid than securities of larger companies. The All Cap Value strategy pursues a value investing approach which may experience periods of underperformance relative to other investment approaches, such as growth investing.

Growth & Value Blend Investment Strategy

The Growth and Value Blend strategy seeks to provide the best of both growth stocks and value stocks in one portfolio by combining large cap growth stocks with selections from our All Cap Value strategy. In analyzing growth stocks for selection, we apply the same quantitative and qualitative analyses as for the value stock selections but with different focus and weightings. We make our growth selections based upon our perception for revenue and earnings growth, financial stability, and good long term fundamentals at reasonable valuation. We benchmark the Growth and Value Blend strategy to the S&P 500 Index because this Index's combination of growth and value securities and its large market capitalization are relevant to the strategy.

Material Risks - The Growth & Value Blend strategy invests primarily in equity securities, which may decline in value due to fluctuations in the overall stock market or due to issuer or industry specific factors. The strategy may invest in stocks of companies that are based or have operations outside the U.S. and which can lose value due to political, social, economic or currency changes. The strategy may invest in small and midsize companies, and securities of such companies are sometimes more volatile and less liquid than securities of larger companies.

Diversifier Investment Strategy

The Diversifier strategy is intended to provide additional diversification to complement our predominantly U.S. equity and fixed income portfolios. This strategy provides exposure to many asset classes which may include: global equities (growth, value, eclectic, small, mid and large cap); global bonds (government and corporate, mid, high and lower quality, step-ups, TIPS and ordinary notes and bonds); agricultural products; precious and industrial metals; currency; short and long/short funds and other strategies. We determine allocations to these asset classes based upon our top-down global macroeconomic assessment, and we invest primarily through mutual and exchange traded funds. We benchmark the Diversifier strategy to the HFRI Fund of Funds Index because this Index's broad range of asset classes reflects the nature of the strategy. We additionally compare the Diversifier to the 90 Day Treasury Bill Plus 300 Basis Points Index due to this Index's benchmarking prevalence and transparency.

Material Risks - The Diversifier strategy invests in multiple asset classes and is subject to various risks that may result in loss of value. Equity securities may decline in value due to fluctuations in the overall stock market or due to issuer or industry specific factors. Investments in stock or bonds of companies that are based or have operations outside the U.S. can lose value due to political, social, economic or currency changes. Risks to foreign investments are typically higher for emerging and less developed markets. Commodities such as agricultural products, precious metals and industrial metals can significantly fluctuate in value due to factors such as changes in inflation expectations or changes in supply and demand. Extreme weather, other natural disasters, civil wars, and geopolitical unrest can negatively impact supply and demand of commodities. Fixed income securities are subject to interest rate risk, which is the risk that securities may decline in value with a rise in interest rates. Interest rate risk is generally greater for fixed income securities with longer maturities or durations. Fixed income securities are subject to credit risk, which is the risk that the issuer of the security will fail to make scheduled interest or principal payments to security holders. Municipal bonds are subject to these interest rate and credit risks and can be impacted by a credit crisis. Mortgage backed securities may additionally be subject to prepayment risk, which is the risk that the weighted average life of the security will shorten when interest rates fall and lengthen when interest rates rise. High yield bonds carry greater default risk than higher rated bonds. The relative value of foreign currencies to domestic currency can rise or fall due to global political, social or economic factors.

EXHIBIT D – LARGE BD/RIA FIRM, MULTIPLE STRATEGIES

Excerpts from Overview of All Programs:

(LARGE BD/RIA FIRM) provides a variety of services designed to meet the varying investment advisory and related needs of individual and institutional clients. Each program described in this brochure offers some or all of the following services: selection of, or assistance in selecting, investment manager(s); ongoing evaluation and review of certain investment manager(s); ongoing evaluation and review of certain mutual funds and exchange traded funds or notes; evaluation and review of the composition of selected portfolios; discretionary portfolio management; custody; execution; implementation services; and reports of activity in a client's account.

In certain programs, clients may have their assets managed by one or more investment managers. Information about each investment manager is in a separate investment manager brochure either provided to the client or available upon request through a client's investment professional. Clients should read and consider carefully the information contained in both this brochure and any relevant investment manager brochure. While (LARGE BD/RIA FIRM) believes that its professional investment advice can work to benefit many clients, there is no assurance that the objectives of any client in any of the programs described will be achieved.

> *Question – is this disclosure sufficient, as to the risk that the investment manager's tactical asset allocation decisions may be wrong, resulting in underperformance relative to the market(s) as a whole?*

Each of (LARGE BD/RIA FIRM)'s and its affiliates' advisory programs may be based on different methodology, and as a result, asset allocation or investment recommendations may differ among programs. (LARGE BD/RIA FIRM)'s investment management services generally rely on fundamental analysis with supplemental technical analysis, which may include charting or cyclical review. Computer technology may be employed to more readily display these factors to portfolio managers. Information is derived from many sources. Personnel involved in providing investment advisory services have access to (LARGE BD/RIA FIRM)'s research facilities as well as (LARGE BD/RIA FIRM)'s and its affiliates' economists and specialists in all major industry groups. Information may be obtained from various other sources including financial publications (including newspapers, research reports, the internet and magazines); industrial manuals and publications; inspections of corporate activities; direct contact with and press releases and other reports released by companies; annual reports, prospectuses and filings made with the Securities and Exchange Commission; research materials prepared by others; governmental reports; timing services; and corporate rating services. (LARGE BD/RIA FIRM) and its affiliates at times may not be free to divulge such information to investment advisory clients or act upon it on their behalf …

An investment in any program described in this brochure is speculative and involves the risk of loss of capital. No guarantee or representation is made that any such program or any underlying investment purchased in connection with such program will achieve its investment objectives or be able to avoid losses. The past performance of a program or any underlying investment purchased in connection with such program is not necessarily indicative of future performance. Neither (LARGE BD/RIA FIRM) nor any of its affiliates makes any representations or warranties in this brochure with respect to the present or future level of risk or volatility in any program or investment, or any program's or investment's future performance or activities.

Excerpts from Program Description:

The LARGE FIRM ETF PROGRAM Program ("LARGE FIRM ETF PROGRAM") is a discretionary, multiple discipline managed account program that combines Exchange Traded Funds and Exchange Traded Notes (collectively and individually "ETFs") with active asset allocation advice.

(LARGE BD/RIA FIRM) assists the client in the establishment and/or review of investment objectives and/or risk profile and/or investment model for each client account through the use of a questionnaire and, if appropriate, updated client information. Based upon (LARGE BD/RIA FIRM)'s review and evaluation of the client's investment objectives, the client and/or (LARGE BD/RIA FIRM) select a portfolio. A portfolio is a multi-style investment approach that allocates assets in the account to specific investment strategies using ETFs.

The [Investment Committee] … of (LARGE BD/RIA FIRM), is responsible for setting the asset allocation of each portfolio, and adjusting the asset allocation from time to time as the [INVESTMENT COMMITTEE] deems appropriate. Specifically, the [INVESTMENT COMMITTEE] allocates each portfolio in varying percentages among various asset allocation categories and classes. The asset allocation categories and classes utilized by the [INVESTMENT COMMITTEE] are subject to change.

Each of the available portfolios will represent a different asset allocation appropriate for a different investment objective/risk tolerance. All asset allocations established from time to time for a portfolio are developed by first starting with a traditional baseline determined to be appropriate based on the relevant investment objective/risk tolerance. Then, strategic asset allocation concepts are applied by looking ahead ten (10) years to determine how each asset class should be weighted in the portfolio to reflect its long-term economic and market forecast. Finally, tactical asset allocation concepts are applied by looking ahead three (3) to twelve (12) months to determine how to shift asset allocation weightings to reflect short-term economic and market forecasts. The asset allocations established reflect many variables. (LARGE BD/RIA FIRM) and its affiliates may offer other investment management and other programs which may be based on different methodologies than LARGE FIRM ETF PROGRAM and which might result in different asset allocations, asset classes or investments than LARGE FIRM ETF PROGRAM.

Types of Investments, Methods of Analysis, Sources of Information and Investment Strategies (All Programs)

As noted above, Overlay Manager purchases and sells securities on the basis of investment instructions furnished by investment managers to Overlay Manager for implementation. In addition, for balanced accounts and Multiple Discipline Accounts, Overlay Manager follows the instructions of the investment managers in determining the extent of rebalancing among multiple investment styles. Subject to the foregoing, Overlay Manager's investment strategies may involve long-term or short-term trading, short sales, margin transactions and option writing, and generally may extend to: exchange-listed, over-the-counter and foreign securities and rights and warrants to acquire the same; corporate, municipal, foreign and U.S. government debt securities, including those guaranteed by such governments or issued by their agencies and instrumentalities and repurchase and reverse repurchase agreements including any of the foregoing; securities options; mortgage-backed or other asset-backed securities and structured notes; certificates of deposit; certain derivative instruments; commercial paper; bankers acceptances; and mutual fund shares. Not all of these strategies are appropriate for all clients, however, and only those strategies believed to be suitable will be used in any given client account or advisory program. It is anticipated that there may be a substantial degree of uniformity in client portfolios of the same investment style as a result of the common investment objectives of the clients who have selected that style.

Overlay Manager may also invest client assets in unaffiliated ETFs. These funds are unmanaged and typically represent U.S. securities markets, industry and market capitalization sectors, non-U.S. country and regional markets, and other types of non-U.S. securities markets and market sectors (e.g., emerging markets). To the extent an ETF represents securities of non-U.S. issuers, it will involve the additional non-U.S. investment risks. Investments in securities of non-U.S. companies involve certain risks in addition to those risks ordinarily associated with investing in securities of domestic issuers. These additional risks include the potentially negative effects of fluctuations in foreign currency exchange rates, future political and economic developments, foreign taxation and differences in auditing and other financial standards. In addition to the wrap or management fees charged at the account level, a client will bear a proportionate share of the fees and expenses incurred by any unaffiliated ETF in which a portion of such client's account is invested.

Question – are the risks of loss disclosed above, and on the prior page, and next page, sufficient? Should there be a listing of the risks, followed by a direction of the client to a description of each risk as contained in a fund's prospectus, or separate account manager's Form ADV Part 2A?

Overlay Manager's investment management services, other than implementation of investment manager investment instructions, generally rely on fundamental analysis with supplemental technical analysis which may include charting or cyclical review. Computer technology may be employed to more readily display these factors to portfolio managers. Information is derived from many sources, which may include: proprietary research; financial publications (including newspapers and magazines), industrial manuals and publications; company visits; inspections of corporate activities; direct contact with and press releases and other reports released by companies; annual reports, prospectuses and filings made with the Securities and Exchange Commission; research materials prepared by other firms; governmental reports; timing services; and corporate rating services.

Methods of Analysis, Investment Strategies and Risk of Loss

Please see "Research in Advisory Programs" for a description or the methods of analysis and investment strategies used in connection with LARGE FIRM ETF PROGRAM.

Investing in securities and other financial instruments involves risks that may affect the value of the securities held in client accounts and result in losses to clients, including the potential loss of the principal amount invested. Potential risks include, among others, losses caused by adverse market conditions, market volatility, limited liquidity and other market action. Clients should be aware that neither(LARGE BD/RIA FIRM) nor any of its affiliates will be responsible for losses in value in client accounts, or for acting or failing to act with respect to client accounts, so long as (LARGE BD/RIA FIRM) acts in good faith.

Question: Is such a disclaimer (i.e., limitation of liability) permitted under the Advisers Act and state common law fiduciary principles?

[**Additional Disclosure for a different investment strategy, as to tax management**]

A … portfolio manager may agree with a client to implement a client-developed investment strategy that the client believes is sensitive to the client's particular tax situation. Neither [LARGE BD/RIA FIRM nor … any …. affiliate provides tax advice, and therefore, they will not be responsible for the development, evaluation or efficacy of any such tax-sensitive strategy. Any such strategy must be developed by the client in consultation with a qualified tax adviser. Certain tax-sensitive strategies that the client may pursue … involve risks. Among others, tax efficient management services involve an increased risk of loss because the client account may not receive the benefit (e.g., realized profit, avoided loss) of securities transactions that would otherwise take place in accordance with the … portfolio manager's investment management decisions for the account.

Question: Is such a broad disclaimer of responsibility – that no tax advice is provided, and that there is no "responsibility" for the development or management of tax-sensitive strategies – possible under the Advisers Act and state common law fiduciary principles?

END OF OUTLINE.