

MEMO# 1932

May 21, 1990

COURT FINDS INVESTMENT ADVISOR A FIDUCIARY SUBJECT TO RULE 10B-5 AND RICO

May 21, 1990 TO: INVESTMENT ADVISER MEMBERS NO. 19-90 INVESTMENT ADVISER ASSOCIATE MEMBERS NO. 18-90 RE: COURT FINDS INVESTMENT ADVISOR A FIDUCIARY SUBJECT TO RULE 10b-5 AND RICO

Attached is a copy of a recent case in which the U.S. Court of Appeals for the Fifth Circuit determined that an investment adviser to a pension plan can be liable for fraud as a fiduciary under Rule 10b-5 of the Securities Exchange Act of 1934 and for violation of the Racketeer Influenced Corrupt Organization Act ("RICO"). The case involves a registered investment advisor who also served as a registered representative of a large brokerage company. The investment adviser was hired by the trustees of a qualified retirement plan on an hourly fee schedule pursuant to a written contract. The adviser did not disclose that he was a registered representative of the broker, that the broker sponsored and approved all of the securities recommended by the adviser or that the adviser would earn commissions from the broker for all of his sales on behalf of the plan. However, subsequent statements to the trustees indicated that the adviser was a registered representative of the broker. The trustees alleged that the adviser informed them that he was paid on an hourly basis so that his recommendations would not be influenced by potential commissions. The plan suffered significant losses from the investments recommended by the adviser. The court established that an adviser's relationship with his client is of a fiduciary nature for purposes of Rule 10b-5. Thus, as a fiduciary, the adviser has an "affirmative duty of utmost good faith to avoid misleading clients. This duty includes disclosure of all material facts and all possible conflicts of interest." The court also provided that its holding does not provide a private cause of action under the Investment Advisers Act, although failure to satisfy applicable regulations could create liability under the Act. Instead, the court's holding only requires considering the fiduciary status of investment advisers in assessing liability under Rule 10b-5. With regard to RICO, the court found that since the trustees' Rule 10b-5 claim was supportable, so was their claim against the adviser under RICO. Therefore, the adviser may be found liable for churning the plan's investments. Finally, the court stated that although the Investment Advisers Act did not afford the relief requested by the trustees, the Act does allow for rescission of the contract between the trustees and the adviser. The court allowed the trustees to pursue any relief that their claim supported, regardless of whether they initially pled an improper remedy. The case was remanded to the trial court for a determination at the adviser's liability. We will keep you informed of further developments.

W. Richard Mason Assistant General Counsel Attachment

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