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ASSET MANAGEMENT FUNDAMENTALS

The Investment Adviser Agent-Principal Relationship

What are Investment Advisers and Whose Money Do They Invest?

Investment advisers earn compensation by providing advice about investing in securities to others. In the United States, investment advisers are registered with the Securities and Exchange Commission ("SEC") or an alternative federal or state regulator depending on size and business activities.

Investment advisers provide advice on a wide range of asset classes, including stocks or bonds. In some cases, advisers also serve as asset managers when they agree to make and implement trading decisions on behalf of their clients. In other cases, advisers only provide advice to clients without trading for them.

Investment advisers work with all types of clients, including individuals, companies, pension plans, and governments. With a wide variety of clients comes a wide variety of investment needs, objectives, and preferences about how to accomplish financial goals.

When an investment adviser acts as an asset manager, it does so as an agent, acting on behalf of its clients rather than itself. The holdings that an asset manager buys or sells are owned by its clients, not the manager. This is true for clients of all types, including individuals, companies, and funds. As the asset owner, clients experience gains and losses from the price changes of the investments made on their behalf. They also receive dividends and interest paid by those investments. Clients pay the costs of investing, such as trading expenses, taxes, and fees.

In some cases, an adviser uses its own money to start or "seed" a new strategy or fund. Some advisers may also permit or require money from employees to be invested alongside clients to promote alignment of interests (such as through a deferred compensation program).

Investors or organizations that invest their own money are not acting for others and are not typically described as "asset managers" or "investment advisers." Some asset managers started as in-house investing firms before expanding to manage money for others.

How Does a Client or Investor Give Authority to the Adviser to Act on Their Behalf?

Clients grant authority to investment advisers to act on their behalf through a contract known as an investment advisory agreement. The investment advisory agreement describes the terms of the relationship between the adviser and client and explains the specific services that the adviser will provide acting as an agent on behalf of the client. The agreement also details the terms of compensation paid to the investment adviser.

In addition to describing the services that the investment adviser will provide, the investment advisory agreement also specifies the limits of the investment adviser's services. For instance, the advisory agreement typically

limits the adviser's authority to investment advice rather than other services such as legal or tax advice.

What is a Fiduciary? What are the Key Sources of Potential Conflict Between an Agent and their Client?

The adviser-client relationship is a fiduciary relationship in which an adviser owes a duty of care and a duty of loyalty to its clients. The fiduciary duty is a legal obligation for the adviser to act in the client's best interest. This legal obligation requires the investment adviser to pursue the client's goals and objectives. In such a relationship, the investment adviser acts as an agent of the client. The fiduciary duty applies to the entire relationship between the adviser and client.

While the duty of loyalty requires investment advisers to put client interests above their own, several circumstances could lead to potential conflicts of interest in an adviser-client relationship. In such circumstances, investment advisers must address potential conflicts of interest that might cause them to provide advice or recommendations that are not disinterested. The adviser must eliminate the conflict, take steps to mitigate the conflict, or provide full and fair disclosure to the client (or both mitigate and disclose the conflict).

For instance, many asset management firms offer both investment advisory and broker-dealer services. Given these dual functions, dually registered firms must make it clear to clients when the firm is acting in an advisory capacity and when the firm is acting in a brokerage capacity. Other examples of potential conflicts of interest include trading between an adviser and client, conflicts that arise by providing services to multiple clients, and benefits received by an investment adviser relating to client portfolio management such as a performance fee. Full and fair disclosure of all material facts relating to the advisory relationship or of a potential conflict is required.

What Legal and Regulatory Frameworks Support/Promote/Enforce this Concept?

Investment advisers act as agents on behalf of their clients (principals). Under the common law of agency, agents are required to act on behalf of and subject to the control of their principals. Agents have a fiduciary obligation to act with appropriate care and diligence and to place the principal's interests above their own. The Investment Advisers Act of 1940 (the "Advisers Act") and rules adopted subsequently outline a framework of regulatory requirements for investment advisers. The SEC administers the Advisers Act through rulemaking, examinations, and enforcement activities. In 1963, the Supreme Court in *SEC v. Capital Gains* recognized the fiduciary nature of the adviser-client relationship under common law and the Advisers Act.

The Advisers Act is focused on advice given by larger advisers with respect to securities. For investment advisers that provide advice regarding asset classes other than securities, other federal regulatory frameworks apply. For instance, the Commodity Futures Trading Commission ("CFTC") has its own requirements for firms that provide advice relating to commodities, swaps, and futures.

Individual states have their own registration and inspection obligations for smaller advisers similar to SEC requirements.

Can Advisers Have Multiple Clients?

Investment advisers offer services to a range of different clients including individual retail investors, institutions, and pension plans. To fulfill the fiduciary obligation of providing advice that is in the best interest of each client, the adviser must understand each client's specific needs and objectives. This typically requires the investment adviser to know the client's financial situation, level of sophistication, investment experience, and financial goals.

Varying client objectives significantly shape investment decisions. Investment advisers must consider whether investment recommendations fall within a given client's risk tolerance level and whether the investment's potential benefits justify the risks. For instance, when advising a retail client with a conservative investment objective, strategies involving margin, leveraged exchange traded products, and complex instruments with limited liquidity may not be appropriate. However, these same investment recommendations may be more appropriate for other investors, such as a sophisticated institutional client with a higher risk tolerance and unique time horizon.

Can Individual Asset Managers Offer Different Strategies?

Some asset managers focus on one specific niche, but many asset managers have the knowledge and capability to offer different solutions to meet the varied needs of different clients. Many asset managers offer a range of strategies, each with a specific focus or investment thesis. There are numerous investment strategies or combinations of investment strategies that clients utilize to meet their investment objectives.

The business structures of large investment advisers often encompass numerous teams and subsidiaries, each providing specialized expertise and independent strategies. In practice, the services of an asset manager are a collection of many unique considerations and investment themes rather than a single top-down homogeneous strategy directed by the firm. When an asset manager reports a total headline amount of assets under management, that number is a total of many different strategies and clients added together.

For example, an asset manager might manage a large-cap growth fund, a mutual fund that invests in large companies with high market capitalization. The same manager might have a different team that invests in smaller companies that it believes are undervalued on the belief that valuations will rise over time consistent with business fundamentals. The same firm might manage fixed income strategies, ranging from those that invest in government and corporate bonds to municipal bonds and money market instruments. Different strategies have different risk and return objectives and often invest in different instruments and asset classes. As a result, they provide different economic results for clients depending on their investment objectives.

How Does the Agency Relationship Translate Through Different Ways Clients Access Advice?

Investment advisers offer advice and invest client money in a variety of ways. Regardless of the form of the chosen investment vehicle, advisers act as agents on behalf of their clients.

Many advisers offer separately managed accounts ("SMAs"), investment accounts that allow clients to directly and individually invest in a portfolio of securities and other instruments managed by the adviser instead of investing in a fund or commingled vehicle along with others. When managing SMAs, investment advisers do not hold client assets. Instead, client assets are maintained by the client (or the client's broker dealer or custodian) and the adviser is granted trading authority.

Mutual funds (also known as registered investment companies or "RICs") are common investment vehicles. Mutual funds provide a structure where the fund's sponsor establishes a fund in which investors can pool their funds together to obtain professional investment advice from an investment adviser. Mutual funds have independent boards of directors or trustees that have a fiduciary duty to the fund. The board arranges for contracts between the fund, the investment adviser, and other fund service providers.

Many investment advisers offer mutual funds and exchange traded funds ("ETFs") that invest in instruments as the strategy and guidelines dictate. Different funds offer different asset classes, instruments, and strategies, offering a variety of choices for the investor. Rather than directly owning the assets that comprise the fund's portfolio, investors own shares of the fund itself while the fund maintains beneficial ownership of the underlying holdings, and the adviser is authorized to manage those holdings on the fund's behalf.

Private funds are similar to mutual funds but are only available to institutional and high net worth investors. Private funds do not have the same registration, governance, and disclosure requirements as broadly available mutual funds given the types of investors who are eligible to own the funds, but typically offer more flexibility and lower operating costs.

Clients have different needs and desire to access investment advice in different ways. For example, a university with an endowment has different needs than individual savers with a 401(k) or 403(b) retirement plan. Investment advisers often think in terms of strategies and how to deliver those strategies through separately managed accounts or commingled vehicles. The same strategies can be made available through multiple channels. The decisions of what strategies to manage and make available greatly influence the business model and organizational structure of an investment adviser.

Regardless of the form of the investment vehicle offered by the adviser, investment advisers manage money and make investment decisions on the client's behalf, acting as an agent of the client.

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About SIFMA and SIFMA AMG:

SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. For more information, visit http://www.sifma.org.

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