Cost as a Component of the Fiduciary Duty of Care

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The growing demand for wealth management services has led to a multiplicity of investment products and services in the financial marketplace, along with new delivery channels. The fees charged for these services vary widely in amount and method of calculation, and regulators have emphasized the importance of disclosure requirements to ensure that investors are informed about the fees they are paying, for what services, and to whom.

The widespread availability of information concerning fees and other investment costs enhances the ability of investors and investment managers to make informed assessments about which investment choices are best suited to the investor’s needs and objectives. Fees and costs can significantly erode investment returns and are an important part of the investment analysis.

The duty of care requires investment advisors, securities broker–dealers, and trustees to be mindful of costs when investing client assets or making investment recommendations. However, cost is only one of a broad array of factors a fiduciary is required to consider under the duty of care. Cost must be considered in the context of the entire fiduciary relationship, the duties associated therewith, and the terms of the fiduciary or investment management agreement.

This article discusses how investment costs are treated as an element of the standard of care applicable to investment advisors, broker–dealers, and trustees. This article discusses only tangentially the related duty of loyalty, which requires a fiduciary to act in the best or sole interests of a fiduciary client and to avoid undisclosed or unauthorized conflict of interests.

The Duty of Suitability under Securities Law

Securities broker–dealers and investment advisors are subject to a standard of care that requires them to make only “suitable” recommendations to their customers. The suitability standard is similar to the standard of care applicable to trustees under trust law, but it is articulated in securities law somewhat differently. Cost is an element in the duty of suitability; it is key in the duty of best execution that applies to broker–dealers and investment advisors. It also arises in the duty of loyalty to act in the best interest of clients that applies to these investment professionals.

The Suitability Rule

Securities broker–dealers that make investment recommendations to clients are subject to the so-called “suitability rule.” The rule is designed to protect clients from unsuitable recommendations and is articulated in Rule 2111 of the Financial Industry Regulatory Authority (FINRA) as follows:

A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile. A customer’s investment profile includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

Although investment advisors are not subject to the Financial Industry Regulatory Authority (FINRA) Rule 2111, the Securities and Exchange Commission (SEC) has said that investment advisors, as fiduciaries under the Investment Advisers Act of 1940, also owe clients a duty to provide only suitable investment advice. To fulfill this obligation, an advisor must make a reasonable determination that its investment advice is suitable for the client based on the client’s financial situation and investment objectives. In addition, the SEC has said an investment advisor owes a duty of care to make a “reasonable investigation” to determine that its recommendations are not based on materially inaccurate or incomplete information.

Moreover, the investment advisor must disclose its investment process to clients. The SEC has noted that Item 8 of Form ADV Part 2A requires an investment advisor to describe its methods of analysis and investment strategies and to explain the material risks involved for each significant investment strategy or method of analysis it uses and particular type of security it recommends. The SEC has not identified “cost” specifically as a factor in the duty of suitability applicable to investment advisors and broker–dealers. As noted below, however, cost is a factor in determining whether the volume of trading in a customer’s account is excessive and unsuitable.
Quantitative Suitability—Cost-to-Equity Ratio

The suitability rule in FINRA Rule 2111 does not mention cost as a specific factor in the suitability analysis. The supplementary material accompanying the rule, however, indicates that "quantitative suitability" is a component of the suitability obligation, requiring a broker to consider whether a series of recommended transactions may be excessive and unsuitable for a customer:

Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.1

The "cost-equity ratio" referred to represents "the percentage of return on the customer's average net equity needed to pay broker-dealer commissions and other expenses."2 FINRA notes that cost-equity ratios as low as 8.7 have been considered indicative of excessive trading, and ratios above 12 generally are viewed as very strong evidence of excessive trading.3

No Duty to Recommend “Least Expensive” Investment

FINRA has said that a broker is not required to recommend the “least expensive” investment as long as the investment is “suitable.” FINRA has stated that cost “ordinarily is only one of many important factors to consider”:

The requirement that a broker’s recommendation must be consistent with the customer’s best interests does not obligate a broker to recommend the “least expensive” security or investment strategy (however “least expensive” may be quantified), as long as the recommendation is suitable and the broker is not placing his or her interests ahead of the customer’s interests. Some of the cases in which FINRA and the SEC have found that brokers placed their interests ahead of their customers’ interests involved cost-related issues. The cost associated with a recommendation, however, ordinarily is only one of many important factors to consider when determining whether the subject security or investment strategy involving a security or securities is suitable.

The customer’s investment profile, for example, is critical to the assessment, as are a host of product- or strategy-related factors in addition to cost, such as the product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility and likely performance in a variety of market and economic conditions. These are all important considerations in analyzing the suitability of a particular recommendation, which is why the suitability rule and the concept that a broker’s recommendation must be consistent with the customer’s best interests are inextricably intertwined.4

Duty of Best Execution

Both brokers and investment advisors have a duty of “best execution” when executing securities, or selecting broker–dealers to execute securities, for their clients.

The investment advisor’s duty of best execution is derived from its status as a “fiduciary” and requires an advisor to “seek to obtain the execution of transactions for each of its clients in such a manner that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances.”5 The SEC has said that an advisor, when seeking best execution, should consider the “full range and quality of a broker’s services” including the broker’s execution capability, commission rate, financial responsibility, responsiveness to the advisor, and the value of any research provided.6

A broker–dealer’s duty of best execution derives from common law agency principles and fiduciary obligations that have been incorporated in FINRA rules enforced under the antifraud provisions of the federal securities laws. Courts have held that the duty of best execution requires a broker–dealer to seek to obtain for its customers’ orders the most favorable terms reasonably available under the circumstances.7 The duty of best execution is codified in FINRA Rule 5310, which provides:

In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used “reasonable diligence” are:

(a) the character of the market for the security (e.g., price, volatility, relative liquidity, and pressure on available communications);
(b) the size and type of transaction;
(c) the number of markets checked;
(d) accessibility of the quotation; and
(e) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.

Duty to Act in Customer’s Best Interests

Although the SEC and FINRA historically have not viewed brokers as “fiduciaries,” increasingly they have recognized that brokers owe a duty to act in the “best interests” of the client, which is akin to the fiduciary duty of loyalty in trust law. FINRA has said the duty to act in the client’s best interests is incorporated in the suitability rule8 and has issued the following guidance on what it means to act in the customer’s best interests:

What does it mean to act in a customer’s best interests?
A 1. In interpreting FINRA’s suitability rule, numerous cases explicitly state that “a broker’s recommendations must be consistent with his customers’ best interests.” The suitability requirement that a broker make only those recommendations that are consistent with the customer’s best interests prohibits a broker from placing his or her interests ahead of the customer’s interests. Examples of instances where FINRA and the SEC have found brokers in violation of the suitability rule by placing their interests ahead of customers’ interests include the following:

- A broker whose motivation for recommending one product over another was to receive larger commissions.
- A broker whose mutual fund recommendations were “designed to maximize his commissions rather than to establish an appropriate portfolio for his customers.”
- A broker who recommended “that his customers purchase promissory notes to give him money to use in his business.”
- A broker who sought to increase his commissions by recommending that customers use margin so that they could purchase larger numbers of securities.
- A broker who recommended new issues being pushed by his firm so that he could keep his job.
- A broker who recommended speculative securities that paid high commissions because he felt pressured by his firm to sell the securities…

Thus, the suitability rule requires a broker–dealer or investment advisor to avoid placing its interests ahead of its customers’ interests with respect to its own compensation as an investment cost.

The Duty of Prudence in Trust Law
Attention to cost also is an element of the duty of prudence in trust law. As articulated in the Restatement of Trusts (Third), the duty of prudence requires a trustee to administer a trust “as a prudent person would, in light of the purposes, terms, and other circumstances of the trust” and requires the exercise of “reasonable care, skill, and caution.”

Cost as an Element of Prudent Investing
The duty to invest trust assets prudently includes the duty to incur only costs that are reasonable and appropriate. The Restatement of Trusts (Third) articulates the duty as follows:

The trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.

(a) This standard requires the exercise of reasonable care, skill, and caution, and to be applied to investments not in isolation but in the context of the trust portfolio as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

(c) In addition, the trustee must:

1. Conform to fundamental fiduciary duties of loyalty and impartiality;
2. Act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and
3. Incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.

Cost as One of Many Considerations
The Restatement of Trusts does not emphasize attention to cost as a predominant factor in the duties associated with administration of a trust but considers it as one of many fiduciary considerations. The Restatement states that many factors must be considered by a trustee in prudently administering a trust:

It is not possible to state all of the factors that are necessary or appropriate for a trustee to take into account in making decisions or taking action in the many diverse aspects of the investment, management, protection, and distribution of trust property.

The Restatement mentions cost as a factor in the administration of a trust, but as one of many considerations:

Among the most obvious of the factors to be considered are the terms and purposes of the trust, the value and nature of the trust estate, the likely duration of the trust, and the amount and timing of its distribution requirements, along with potentially associated needs for liquidity, stability of income flow, and preservation of (or growth in) the purchasing power of capital. Inevitably related to some of the foregoing are the needs, independent resources, and other personal and financial circumstances and concerns or goals of the various beneficiaries. These various factors together offer illumination regarding such important considerations as the risk tolerance and tax positions of the trust and its beneficiaries, as well as other concerns that are fundamental to prudent decisions and strategies in matters ranging from investment management to discretionary distributions.

Other considerations and circumstances (at some risk of redundancy) that are likely to be important to prudent administration of a trust include: the expected returns (including both income and capital elements) or other benefits of various courses of action that might be pursued, plus their anticipated tax and cost consequences; any special value or relationship an asset or course of action may have to the purposes of the trust or to one or more of the beneficiaries; the skills and facilities of, or reasonably available to, the trustee; and general economic conditions and potential effects of inflation or deflation.

Accordingly, as articulated in the Restatement, cost is not the foremost consideration a trustee must consider in prudently administering a trust, but it is an important one nevertheless.
Trustee Compensation

A significant part of the cost incurred in the administration of a trust is the trustee’s own compensation. The Restatement of Trusts (Third) explicitly recognizes that a trustee is entitled to reasonable compensation for its services:

(1) A trustee is entitled to reasonable compensation out of the trust estate for services as trustee, unless the terms of the trust provide otherwise or the trustee agrees to forgo compensation.16

In determining the reasonableness of a trustee’s compensation, relevant factors include the trustee’s experience, skill, and facilities, local custom, the time devoted to trust duties, amount and character of the trust property, degree of difficulty and responsibility, degree of risk assumed, the nature and costs of services rendered by others, and the quality of the trustee’s performance.17

The Restatement also recognizes that a trustee is entitled to reimbursement for expenses properly incurred in the administration of the trust:

(2) A trustee is entitled to indemnity out of the trust estate for expenses properly incurred in the administration of the trust.18

With respect to costs for services provided by others, the Restatement states that the amount of the trustee’s compensation is relevant in considering whether a trust should be charged with such costs:

The amount of compensation received by a trustee is relevant in determining whether certain costs of others’ services are reimbursable. … This is particularly so of costs of hiring advisors, agents, and others to render services expected or normally to be performed by the trustee. Conversely, even proper expenses of this type may affect what is reasonable compensation for the trustee.19

As an illustration of this principle, the Restatement of Trusts (Third) includes the following example:

A trustee claims reimbursement for a fee paid to an investment advisor. The fee itself is reasonable. Reimbursement will ordinarily be allowed if the trustee is serving without compensation. If, however, the trustee receives normal compensation, especially a full statutory or settler-prescribed fee, reimbursement will depend on the nature and purposes of the consultation and how the advisor’s employment relates to the responsibilities reasonably expected of the particular trustee or to those that are customary for trustees in the relevant community.20

The Restatement also acknowledges that the terms of the trust agreement may govern a trustee’s compensation, and may be adjusted:

When the terms of a trust provide that the trustee is to receive certain compensation or no compensation, the trustee’s right to compensation is ordinarily governed by that provision. … If the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation, or may allow the trustee to resign.21

A trustee’s compensation also may be increased or decreased by agreement between the trustee and beneficiaries.22

Some state statutes prescribe formulas for determining the amount of a trustee’s compensation and usually provide that trustee fees are to be based on specified percentages of principal, or income and principal, of the trust.23

A trustee that acts both as trustee and as executor generally is entitled to “such compensation as is reasonable in view of all the duties performed.”24 If there are two or more trustees for a trust, the reasonable compensation for multiple trustees may be higher than for a single trustee “because the normal duty of each trustee to participate in all aspects of administration … can be expected not only to result in some duplication of effort but also to contribute to the quality of administration.”25

Third-Party Expenses

The Restatement recognizes that a trustee is not required to perform directly all of the investment functions for a trust:

The trustee is not required personally to perform all aspects of the trust’s investment activities, even if the trustee is a professional or institutional fiduciary with competence and experience in financial matters.26

Correspondingly, the Restatement recognizes that a trustee may properly incur and pay reasonable expenses of third parties in the administration of a trust:

A trustee can properly incur and pay expenses that are reasonable in amount and appropriate to the purposes and circumstances of the trust and to the experience, skills, responsibilities, and other circumstances of the trustee.27

In this regard, the Restatement states that the trustee has an implicit duty to be cost-conscious:

Implicit in a trustee’s fiduciary duties is a duty to be cost-conscious. See generally § 77 on the duty to act with prudence.28

In discussing what expenses are proper and reasonable, the Restatement recognizes that a trustee is not limited to incurring expenses that are necessary or essential:

What expenses are proper and reasonable? A trustee is not limited to incurring expenses that are “necessary” or essential, but may incur expenses that, in the exercise of fiduciary judgment … are reasonable and appropriate in carrying out the purposes of the trust, serving the interests of the beneficiaries, and generally performing the functions and responsibilities of the trusteeship. … Although a trustee is expressly or impliedly authorized or required to incur a particular type of expense, the trustee has a duty to exercise such care and skill as a person of ordinary prudence would exercise in incurring the expense.29

The Restatement explicitly recognizes that a trustee may properly incur reasonable
expenses in employing lawyers, brokers, or other agents or advisors when appropriate to the sound administration of the trust. However, such expenses may not be proper if the expenses are for services that duplicate those services for which the trustee is compensated and expected to perform:

[A] trustee cannot properly incur expenses for another to perform functions the trustee is compensated—and thus expected—to perform personally. Thus, the method of fixing a trustee’s compensation and the amount of that compensation, are relevant in determining whether certain costs of other’s services are payable or reimbursable from the trust estate. Even proper expenses of this type, that is, expenses that are neither unreasonable nor impermissible, may affect what is appropriate compensation for a trustee under a typical “reasonable compensation” standard.

Accordingly, a trustee must consider the totality of fees and expenses in addition to its own compensation in considering what costs are appropriate and reasonable charges for its trust accounts.

Uniform Prudent Investor Act
The duty of prudent investing in trust law is codified in the Uniform Prudent Investor Act (UPIA). The UPIA was approved and recommended for enactment in all the states by the National Conference of Commissioners on Uniform State Laws in 1994. Nearly all of the states have adopted the UPIA or a variation thereof.

The UPIA establishes a portfolio standard of care for trust investing based on a variety of factors, none of which include cost:

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

1. general economic conditions;
2. the possible effect of inflation or deflation;
3. the expected tax consequences of investment decisions or strategies;
4. the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
5. the expected total return from income and the appreciation of capital;
6. other resources of the beneficiaries;
7. needs for liquidity; regularity of income, and preservation or appreciation of capital; and
8. an asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee’s representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

Although cost is not a factor in the principal standard of care under the UPIA, the UPIA does not ignore cost but addresses it separately. In accordance with the principles of the Restatement, the UPIA states that a trustee may incur only costs that are “appropriate and reasonable”:

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

The official comment to the UPIA states: “Wasting beneficiaries’ money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.”

The UPIA affords a trustee wide latitude to delegate investment functions to third parties, provided the trustee exercises care, skill, and caution in doing so. In this regard, the trustee also is subject to the duty to minimize costs:

Costs. The duty to minimize costs that is articulated in Section 7 of this Act applies to delegation as well as to other aspects of fiduciary investing. In deciding whether to delegate, the trustee must balance the projected benefits against the likely costs. Similarly, in deciding how to delegate, the trustee must take costs into account. The trustee must be alert to protect the beneficiary from “double dipping.” If, for example, the trustee’s regular compensation schedule presumes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.

Uniform Trust Code
The Uniform Trust Code was drafted in close coordination with the writing of the Restatement of Trusts (Third) and effectively codifies the Restatement. The Code is the first national codification of the law of trusts and is intended to mitigate the fragmentation of state trust law by providing states with precise, comprehensive, and easily accessible guidance on trust law questions.

With respect to costs, the Uniform Trust Code, like the Restatement, recognizes that
a trustee generally is entitled to "reasonable compensation under the circumstances" absent terms in the trust agreement specifying trustee compensation:

**COMPENSATION OF TRUSTEE.**

(a) If the terms of a trust do not specify the trustee's compensation, a trustee is entitled to compensation that is reasonable under the circumstances.39

Even if the trust agreement specifies the amount of trustee compensation, the Uniform Trust Code provides for adjustment by a court if the trustee's duties are "substantially different" from those contemplated when the trust was created or if the specified compensation is "unreasonably low or high."40

The comments to the Uniform Trust Code require close examination of the trustee's services and responsibilities in establishing the amount of compensation, and a downward adjustment of fees may be required if the trustee has delegated investment authority to outside managers:

In setting compensation, the services actually performed and responsibilities assumed by the trustee should be closely examined. A downward adjustment of fees may be appropriate if a trustee has delegated significant duties to agents, such as the delegation of investment authority to outside managers. … On the other hand, a trustee with special skills, such as those of a real estate agent, may be entitled to extra compensation for performing services that would ordinarily be delegated.41

The Uniform Trust Code also addresses compensation when there is more than one trustee for a trust:

Because "trustee" … includes not only an individual trustee but also cotrustees, each trustee, including a cotrustee, is entitled to reasonable compensation under the circumstances. The fact that a trust has more than one trustee does not mean that the trustees together are entitled to more compensation than had either acted alone. Nor does the appoint-

tment of more than one trustee mean that the trustees are eligible to receive the compensation in equal shares. The total amount of the compensation to be paid and how it will be divided depend on the totality of the circumstances. Factors to be considered include the settlor's reasons for naming more than one trustee and the level of responsibility assumed and exact services performed by each trustee. Often the fees of cotrustees will be in the aggregate higher than the fees for a single trustee because of the duty of each trustee to participate in administration and not delegate to a cotrustee duties the settlor expected the trustees to perform jointly. … The trust may benefit in such cases from the enhanced quality of decision-making resulting from the collective deliberations of the trustees.42

The Uniform Trust Code recognizes that a trustee is entitled to be reimbursed for expenses incurred in administering a trust:

**REIMBURSEMENT OF EXPENSES.**

(a) A trustee is entitled to be reimbursed out of the trust property, with interest as appropriate, for: (1) expenses that were properly incurred in the administration of the trust; and (2) to the extent necessary to prevent unjust enrichment of the trust, expenses that were not properly incurred in the administration of the trust.43

The comments to the Uniform Trust Code state that a trustee has the authority to expend trust funds as necessary in the administration of the trust, including expenses incurred in the hiring of agents.

Like the Restatement and Uniform Prudent Investor Act, the Uniform Trust Code provides that a trustee may incur only "reasonable" costs:

**COSTS OF ADMINISTRATION.**

In administering a trust, the trustee may incur only costs that are reasonable in relation to the trust property, the purposes of the trust, and the skills of the trustee.44

This duty applies with respect to the delegation of functions to third parties in addition to the trustee's own activities on behalf of a trust:

The duty not to incur unreasonable costs applies when a trustee decides whether and how to delegate to agents, as well as to other aspects of trust administration. In deciding whether and how to delegate, the trustee must be alert to balancing projected benefits against the likely costs.

To protect the beneficiary against excessive costs, the trustee should also be alert to adjusting compensation for functions which the trustee has delegated to others.

The obligation to incur only necessary or appropriate costs of administration has long been part of the law of trusts.45

**Costs Associated with Mutual Fund Investing**

The Restatement recognizes that, in most of the states, statutes have been enacted allowing trustees to invest trust assets in securities of mutual funds for which the trustee or an affiliate provides services for compensation.46 The Restatement notes that "[t]hese statutes require the trustee to satisfy certain requirements set out in the statute concerning information the trustee must report to beneficiaries about the rate of compensation and the method by which the compensation was determined." The Restatement emphasizes that such a statute "does not relieve the trustee of its normal duty to exercise prudence. … [n]or does it dispense with the trustee's fundamental duty to act in the interest of the beneficiaries, its duty of impartiality, or the other fiduciary duties of trusteeship." In particular, the Restatement cautions:

[T]he trustee cannot properly confine its investments to the proprietary mutual fund offerings if this would impair the trustee's ability to manage both uncompensated and compensated risk through proper diversification and through asset allocation appropriate to the particular trust; and the trustee must be sufficiently aware of overall costs associated with other mutual fund alternatives to enable the trustee to fulfill its important responsibility to be cost conscious in managing the trust's investment program. … Furthermore, the use of
proprietary mutual funds for a trust's investment program must not result in the trustee receiving more than the reasonable overall compensation ... appropriate to its services to the trust, taking account of the trustee's mutual fund duties and compensation.47

The Uniform Prudent Investor Act echoes the Restatement and emphasizes the need for "careful cost comparisons":

Concerns over compensation and other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee. ... [It] is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.48

The Uniform Trust Code, in provisions concerning the duty of loyalty, articulates additional standards concerning costs incurred by a trustee when investing fiduciary assets in mutual funds:

(f) An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the prudent investor rule of [Article] 9. In addition to its compensation for acting as trustee, the trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust. If the trustee receives compensation from the investment company or investment trust for providing investment advisory or investment management services, the trustee must at least annually notify the persons entitled under Section 813 to receive a copy of the trustee's annual report of the rate and method by which that compensation was determined.49

The comments to the Code explain that subsection (f) is intended to allow trustees to receive fees for providing mutual fund services but notes that there has been litigation challenging such fees in some cases:

This exception applies even though the mutual fund company pays the financial service institution trustee a fee for providing investment advice and other services, such as custody, transfer agent, and distribution, that would otherwise be provided by agents of the fund. Mutual funds offer several advantages for fiduciary investing. By comparison with common trust funds, mutual fund shares may be distributed in-kind when trust interests terminate, avoiding liquidation and the associated recognition of gain for tax purposes. Mutual funds commonly offer daily pricing, which gives trustees and beneficiaries better information about performance. Because mutual funds can combine fiduciary and nonfiduciary accounts, they can achieve larger size, which can enhance diversification and produce economies of scale that can lower investment costs.

Mutual fund investment also has a number of potential disadvantages. It adds another layer of expense to the trust, and it causes the trustee to lose control over the nature and timing of transactions in the fund.

Mutual fund investment also has a number of potential disadvantages. It adds another layer of expense to the trust, and it causes the trustee to lose control over the nature and timing of transactions in the fund.

This section (f) of the Uniform Prudent Investor Act bars financial institution trustees from receiving a fee from the income of a trust for providing investment advice and other services, such as custody, transfer agent, and distribution, that would otherwise be provided by agents of the fund. Mutual funds offer several advantages for fiduciary investing. By comparison with common trust funds, mutual fund shares may be distributed in-kind when trust interests terminate, avoiding liquidation and the associated recognition of gain for tax purposes. Mutual funds commonly offer daily pricing, which gives trustees and beneficiaries better information about performance. Because mutual funds can combine fiduciary and nonfiduciary accounts, they can achieve larger size, which can enhance diversification and produce economies of scale that can lower investment costs.

Mutual fund investment also has a number of potential disadvantages. It adds another layer of expense to the trust, and it causes the trustee to lose control over the nature and timing of transactions in the fund.

Subsection (f) attempts to retain the advantages of mutual funds while at the same time making clear that such investments are subject to traditional fiduciary responsibilities. Nearly all of the States have enacted statutes authorizing trustees to invest in funds from which the trustee might derive additional compensation. Portions of subsection (f) are based on these statutes. Subsection (f) makes clear that such dual investment-fee arrangements are not automatically presumed to involve a conflict between the trustee's personal and fiduciary interests, but subsection (f) does not otherwise waive or lessen a trustee's fiduciary obligations. The trustee, in deciding whether to invest in a mutual fund, must not place its own interests ahead of those of the beneficiaries. The investment decision must also comply with the enacting jurisdiction's prudent investor rule. To obtain the protection afforded by subsection (f), the trustee must disclose at least annually to the beneficiaries entitled to receive a copy of the trustee's annual report the rate and method by which the additional compensation was determined. Furthermore, the selection of a mutual fund, and the resulting delegation of certain of the trustee's functions, may be taken into account under Section 708 in setting the trustee's regular compensation. See also Uniform Prudent Investor Act Sections 7 and 9 and Comments; Restatement (Third) of Trusts: Prudent Investor Rule Section 227 cmt. m (1992).
Conclusion

Investment advisors, broker–dealers, and trustees all act in a fiduciary capacity when they make investment recommendations or investment decisions for client accounts. As such, they are subject to fiduciary standards of care that require them to consider cost as one among many factors in an investment recommendation or investment decision. Cost is not the only factor in the standard of care—or even the most important one—but it must be taken into account by the investment professional when acting in a fiduciary capacity for the account of others. Costs include the fiduciary’s own compensation as well as fees incurred in executing securities transactions and expenses associated with different types of investments, such as mutual funds. Securities brokers and investment advisors are subject to the suitability rule under the securities laws, and trustees are subject to the prudent investor rule under trust law. Although the rules are articulated differently, they require the investment professional to be attentive to investment costs.

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Endnotes

1. FINRA Rule 2111. With respect to institutional customers, the rule provides: “A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member’s or associated person’s recommendations. Where an institutional customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.”

2. See Status of Investment Advisory Programs under the Investment Company Act of 1940, Investment Company Act Release No. 22579 (March 24, 1997) (in the context of adopting a final rule providing for a non-exclusive safe harbor from the definition of investment company for certain investment advisory programs, citing to Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1408 (March 16, 1994) (proposing a rule under the Advisers Act Section 206(4))’s antifraud provisions that would expressly require advisers to give clients only suitable advice; the rule would have codified existing suitability obligations of advisers).

3. See SEC Staff Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, January 2011, p. 28.

4. FINRA Rule 2111, supplementary material .05(c).


7. Id.


10. See NASD Notice to Members 01-22, NASD Regulation Reiterates Member Firm Best Execution Obligations And Provides Guidance To Members Concerning Compliance.

11. FINRA Regulatory Notice 11-02: “[It] is well-settled that a ‘broker’s recommendations must be consistent with his customer’s best interests’ and are ‘not suitable merely because the customer acquiesces in [them].’” Dane S. Faber, Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23–24 (February 10, 2004); see also Department of Enforcement v. Bendtsen, No. C01020205, 2004 NASD Discip. LEXIS 13, at *12 (NAC August 9, 2004) (“[A] broker’s recommendations must serve his client’s best interests and the test for whether a broker’s recommendations are suitable is not whether the client acquiesced in them, but whether the broker’s recommendations were consistent with the client’s financial situation and needs”).


13. Restatement of Trusts (Third) § 77. The Restatement emphasizes that the general duty of prudence is “one of conduct not of performance.” Id. General comment.

14. Restatement of Trusts (Third) § 90.

15. Restatement of Trusts (Third), comment b(1).

16. Restatement of Trusts (Third) § 38, Trustee’s Compensation and Indemnification.

17. Id. comments a and c(1).

18. Restatement of Trusts (Third) § 38.

19. Id. comment c(1).

20. Id.

21. Id. comment e.

22. Id. comment f.

23. Id. comment c.

24. Id. comment h.

25. Id. comment i.

26. Restatement of Trusts (Third) § 80 comment f(1): (“The qualities and qualifications for which trustees are properly selected for fiduciary roles, and the scope and complexity of the delegation programs of some trusts, are so diverse that prescriptions for prudent behavior in the delegation of investment functions cannot be expressed in simple or precise legal rules. With professional advice as needed, the trustee personally must at least define the trust’s investment objectives. In addition, the trustee must personally either formulate or approve the trust’s investment strategies and programs. Admittedly, even these limited generalizations are necessarily and desirably couched in terms that are less than self-defining. In other matters, the trustee must exercise reasonable care, skill, and caution in determining what investment responsibilities to delegate. There, fiduciary prudence must be exercised as well in selecting an agent and establishing the terms of the delegation, and also in supervising or reviewing the agent’s performance and compliance with the terms of the delegation, in all a manner appropriate to the circumstances and conditions of the delegation and competence of both agent and trustee.”).