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Dealing with Investment Errors

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No professional investment adviser would intentionally make a trade or investment error. However, such errors occur from time to time. Formulating an appropriate response to investment errors can be challenging for investment advisers, not only because there is no universally accepted definition of "investment error," but also because there is no bright line rule for identifying, rectifying or reimbursing advisory clients for investment errors. This lack of uniform approach to error identification and remediation provides investment advisers with some flexibility to develop policies for addressing investment errors, as long as those policies adhere to certain guiding principles and are appropriately disclosed.

An investment adviser may assume, with little additional analysis, that it has absolute liability for an investment error. Depending on the facts and circumstances of a particular case, however, it may not always be necessary for an investment adviser to reimburse a client for losses resulting from an error, either because the advisor has no legal obligation to do so, because a third party may be liable, or because the error is excusable for some other reason.

The purpose of this article is to discuss guiding principles found in applicable law regarding investment errors and to set out a framework for analyzing investment errors, sources of liability, and guidelines for reimbursing clients for errors for which an investment adviser is contractually responsible.

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I. Legal Framework

A. Identifying and Defining "Investment Error"

The terms "investment error" and "trade error" are not defined in the Investment Advisers Act of 1940 Act, as amended (Advisers Act), or under other applicable law. Moreover, there is limited guidance from the Securities and Exchange Commission (SEC) and its Staff as to what amounts to a trade error. Although not required by the securities laws, it is a generally accepted practice for investment advisers to adopt policies and procedures that provide guidelines for resolving trade errors.[1] The Compliance Program Adopting Release is silent regarding error correction procedures; however, the SEC has stated in an enforcement action that an investment adviser should have policies and procedures to address trade errors.[2]

Trade error policies and procedures typically indicate that the investment adviser is subject to legal and contractual obligations when resolving a trade error, including a fiduciary obligation and a standard of care under its investment management agreements. Policies and procedures are designed to ensure that such duties are considered when correcting a trade error.

The specific provisions of investment adviser trade error correction policies differ significantly from investment adviser to investment adviser, based in part on the nature of the investment adviser's client base, the investment adviser's general approach to compliance policies and procedures, and the historical experience and practice of the investment adviser. The highly fact-specific nature of trade error analysis, along with the lack of specific SEC rules or guidance on trade error correction, has led to the prevalence of procedures that tend to provide general guidelines for identifying and assessing potential trade errors.

When establishing error correction policies, it is important for the investment adviser to develop a definition of investment error. In general, procedures broadly define "trade error" to mean a case in which the investment adviser has purchased or sold a financial instrument for a client account, that action is then determined to have been a mistake, and the error results in a financial gain or loss for the client.[3] In our experience, investment advisers typically classify errors in several categories. Examples of errors may include:

- Purchases or sales of an incorrect or unintended financial instrument or number of financial instruments for a client account;
- Purchases or sales of financial instruments for the incorrect or unintended client account;
- Purchases or sales of financial instruments that are not authorized by the client's investment guidelines or applicable law or regulation;
- Purchase or sale transpositions (where an intended purchase is entered as a sale, or vice versa); and
- Trade misallocations.[4]

Error correction procedures may call for different responses to different categories of errors.

Upon discovering a possible error, an investment adviser should gather as much information about the situation as possible. Initial questions the investment adviser may wish to consider when determining whether an error has occurred include the following:

- What actually happened (that is, describe the facts and circumstances surrounding the error and attempt to identify the source and cause of the error)?
- Is it truly an error or is it something else (for example, market action, or *force majeure*)?
- Is the investment adviser or its supervised persons solely responsible for the error or was it caused by, or contributed to by, actions of a third party?[5]
- Was the error a result of the investment adviser's investment decisionmaking or did it relate to transaction processing, trade allocation or some other administrative or operational aspect of the investment adviser's implementation of its investment decisions?[6]

B. Evaluating Sources of Liability

Once an investment adviser has determined that an investment error has occurred and has

considered the factual information available to it, the investment adviser should consider the potential sources of liability that exist.

1. Fiduciary Duty

Section 206 of the Advisers Act makes it unlawful for any investment adviser (i) to employ any device, scheme, or artifice to defraud any client or prospective client, (ii) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client or (iii) to engage in any act, practice or course of business which is fraudulent, deceptive, or manipulative.[7] In addition to these specific provisions, Section 206 of the Advisers Act also imposes on an investment adviser a fiduciary duty by operation of law.[8] As a fiduciary, an investment adviser has an affirmative duty to act solely in the best interests of its clients and to make full and fair disclosure of all material facts.[9] Accordingly, while the Advisers Act does not impose a specific duty of care on investment advisers, investment advisers are required to act in the best interest of their clients.

a. Hedge Clauses.

Consistent with these fiduciary duties, an investment adviser may seek to contractually limit its liability to clients for losses. The SEC Staff had historically taken the position that the antifraud provisions of Section 206 of the Advisers Act may be violated by the use of a "hedge clause"[10] or other exculpatory provision in an investment advisory agreement that seeks to limit an investment adviser's liability for losses incurred by its client to liability for "gross negligence" or "willful misconduct."[11] In *Auchincloss*, the SEC Staff stated that any exculpatory clause that limited the liability of an investment adviser to "gross negligence" or "willful misconduct" may be voidable under Section 215(a) of the Advisers Act on the grounds that "the express denial of liability … may mislead a client into believing he has waived certain rights of action… ."[12] The SEC Staff reasoned that applicable state or federal law may require a greater degree of care by a fiduciary, in which case a hedge clause using those adjectives may mislead clients into believing that they have waived a right of action based on the investment adviser's ordinary negligence (or misconduct). In *Auchincloss*, the SEC Staff concluded, however, that it would not recommend enforcement action if Auchincloss revised the terms of its investment advisory contract to include language suggested by the SEC Staff, which included a statement that the investor was not precluded from recourse against the investment adviser for liability arising under the federal securities laws.[13] In later no action letters, the SEC Staff affirmed its position that hedge clauses that limit an investment adviser's liability to acts involving gross negligence or willful malfeasance are likely to mislead unsophisticated clients into believing that they have appropriate non-waivable rights, even if the clause specifically provides that rights under federal or state law cannot be waived.[14]

The SEC Staff has, however, since modified its prior position.[15] In *Heitman*, the SEC Staff stated that an investment adviser's use of a hedge clause and appropriate non-waiver disclosure would not be *per se* violations of the antifraud provisions of Section 206 of the Advisers Act. Instead, the SEC Staff took the position that whether the use of hedge clauses violates Section 206 of the Advisers Act depends on all surrounding facts and circumstances, and would take into account the form and content of the particular clause, any oral or written communications between the adviser and the client about the hedge clause, and the particular circumstances of the client. The SEC Staff declined to take a position on whether the use of any specific hedge clause and non-waiver disclosure would mislead any particular client because of the fact-intensive nature of the inquiry.

It is interesting to note that, historically, the SEC Staff did not apply the *Auchincloss* position to advisory contracts involving registered investment companies. Section 17(i) of the Investment Company Act of 1940 (1940 Act) specifies a minimum standard of care for investment advisory and principal underwriting agreements with registered investment companies. Under Section 17(i), an investment adviser or principal underwriter may limit its liability to losses other than those resulting

from its willful misfeasance, bad faith, or gross negligence, in the performance of its duties, or by reason of its reckless disregard of its obligations and duties under such contract or agreement.[16] The SEC Staff's position in *Auchincloss*—requiring deference to state law and fiduciary duty in general—arguably resulted in a stricter liability standard under the Advisers Act than that which was applied to investment advisers to investment companies under the 1940 Act. We are aware of no case in which the enforceability of a provision in a contract with a registered investment company that eschews liability for ordinary negligence has been invalidated.

b. General Fiduciary Principles: The *Lerner* Letter

The Advisers Act does not contain any specific provisions addressing an investment adviser's responsibility for investment errors. Nevertheless, the SEC Staff has interpreted an investment adviser's fiduciary duties under federal law to mean that, assuming the adviser has violated its standard of care and, even more important, assuming an actual "error" has occurred, the adviser is responsible for resulting losses.[17] In *Lerner*, Department of Labor (DOL) investigators discovered that advisers were entering into arrangements with broker-dealers when a trading error occurred in one of the adviser's accounts. The broker-dealers who originally executed the trade agreed to carry the loss temporarily in return for a commitment from the adviser to direct to the broker-dealer sufficient commission revenues to cover the amount of the loss. The DOL was considering litigation against the advisers engaging in such practices, but requested the SEC Staff's advice regarding the applicability of Section 28(e) of the Securities Exchange Act of 1934, as amended (Exchange Act), to such commission arrangements. The SEC Staff concluded that an adviser and broker-dealer engaging in such error correction practices would not be able to rely on the safe harbor of Section 28(e) and stated that "if an investment manager makes an error while placing a trade for an account, then the investment manager, in order to comply with its obligation to its customer, [must bear any costs] of correcting such trade."[18] It should be emphasized that this statement was made in the context of denying an investment adviser the ability to use soft dollar credits (which are the property of the investment adviser's clients) to reimburse clients for presumed investment adviser liability. We do not believe that the language cited above should be read to imply a regulatory standard of absolute liability for all investment adviser errors – regardless of the origin or circumstance – that may lead to a client loss.[19]

2. Contractual Standard of Care/State Law Concepts of Fiduciary Duty

State law concepts of fiduciary duty, the contractual standard of care, and legal concepts of loss calculation are relevant factors when determining whether, and in what event, to reimburse a client for an investment error.

Lerner makes clear that, as between the client on the one hand and the investment adviser on the other, it is the investment adviser that is responsible for losses in connection with a trading error made by the investment adviser for which it has contractual responsibility. As noted above, however, the SEC Staff has also recognized that contractual limitations of liability may modify these responsibilities. The standard of care of an investment adviser is typically negotiated between the investment adviser and the client and set forth in the advisory agreement. For example, a contract may provide that an investment adviser is not liable for any act or omission in connection with providing services under the contract absent willful misfeasance, bad faith, gross negligence or reckless disregard of its obligations or duties.[20] In this case, the investment adviser would be liable for an investment error only if the error resulted from a breach of the standard of care, that is, gross negligence or more culpable conduct. To determine an investment adviser's liability for losses, if any, one should look to the terms of its advisory agreement with its clients and the applicable state common law duty of care.

In construing the scope of fiduciary duty, the law of trusts provides useful guidance.[21] In this regard, it is well established that while

a trustee owes a duty to beneficiaries to "act with prudence," and to take such actions "as a prudent person would for the protection and preservation of trust property," a trustee is not liable for errors that occur while the trustee is acting in a diligent manner in good faith.[22] Almost all states have adopted some form of the "prudent investor" rule.[23] A fiduciary is obligated to operate its business according to a high standard of professionalism, and to make provision for appropriate safeguards to limit the risk that investment adviser errors could lead to client harm.[24] For example, Delaware courts are hesitant to allow claims for breach of fiduciary duty involving "good faith mistakes" where organizational documents specifically limit liability to acts involving willful misconduct, bad faith, or other higher standard of liability.[25]

Whether an investment adviser has a legal obligation to reimburse an account for a loss to which an investment adviser error has contributed will turn on an analysis of facts and circumstances and to the application of concepts from the laws of contract and negligence – reasonable reliance, contributory negligence, causation, and other qualifying or mitigating elements. And of course, in the case of the ultimate investment adviser "error" – a poor (or poorly timed) investment decision – there is ample support for the notion that a fiduciary does not breach its duty merely by making, in the exercise of its investment discretion, an unwise investment decision.[26]

C. Calculating an Appropriate Reimbursement Amount

Once the investment adviser determines that an error has occurred for which the investment adviser is liable to the client, either under the client agreement or state fiduciary law, consideration should be given to whether the error is compensable and what would be an appropriate loss calculation methodology. The SEC has not issued rulemakings or guidance specifically addressing loss calculation methodology in the context of investment adviser trade errors. Under other federal securities laws, recovery of damages is generally limited to actual damages.[27] For example, damages under Section 12 of the Securities Act of 1933 are generally limited to the return of the purchase price of the security with interest, and do not, for example, mandate an opportunity cost analysis.

1. General Principles and the "Total Return" Approach

Courts are likely to look to state trust law in determining the proper manner for a fiduciary to reimburse a client for an error. Advisers can use this as a guide in preparing error correction guidelines. The Restatement (Third) of Trusts (Restatement) provides that the basic principle of liability for breach of fiduciary duty is that the injured beneficiary should be made whole, that is, that the beneficiary should be restored to the same condition as if the wrong had not been committed.[28] How the beneficiary is made whole may vary depending on the circumstances and the equities of the case.[29] For example, when a trustee who has broad investment authority fails to invest, the trustee may be liable for any income (ordinarily determined by reference to a fixed rate of interest) the uninvested funds would have earned if they had been invested properly, but not for forgone gains.[30] Similarly, where a trustee makes an improper investment, he is generally liable for any loss plus interest (if any).[31]

The problem with this historical approach is that trustees are no longer supposed to invest exclusively to produce reliable income streams, while preserving principal. Modern prudent investor rules adopted by many states, including Massachusetts and New York, now require trustees, consistent with the mandate of the trust instrument, to invest for total return. According to the statutes, a trustee shall consider "the expected total return from income and the appreciation of capital" when investing and managing trust assets.[32]

The traditional approach to damages discussed above may not be adequate or appropriate, given the focus on total return. Under a "total return" approach for damages, a trustee's liability for improper investment conduct is measured by reference to total return, positive or negative. This is the approach taken in Section 100 of the Restatement, which provides that if a trustee purchases imprudent, or otherwise improper, investments for the trust

estate, the recovery in such case ordinarily would be:

> the difference between (1) the value of those investments and their income and other product at the time of surcharge and (2) the amount of funds expended in making the improper investments, increased (or decreased) by a projected amount of total return (or negative total return) that would have accrued to the trust and its beneficiaries if the funds had been properly invested.[33]

Depending on the nature of the error and the availability of relevant data, this approach can be implemented by referring to (i) the performance of all or a relevant portion of the proper investments of the trust in question, (ii) the performance of all or part of the portfolios of comparable trusts, or (iii) the performance of some suitable securities index or other benchmark portfolio with such adjustments as may be appropriate.[34]

The primary objection raised to a "total return" approach has not been one of policy or principle, but one of the practical difficulties in measuring appropriate damages under such an approach. In the past, courts have been hesitant to allow recovery based on some representative measure of total return performance because they regarded it as speculative and difficult to calculate. This approach to damages, however, has been made easier by the wide availability of relevant performance data.

State courts have demonstrated the ability to apply the "total return" approach when calculating damages. For example, in *Noggle v. Bank of America*,[35] a case in which residuary beneficiaries of several related testamentary trusts sued the bank trustee for having invested the trust's assets for the benefit of the income beneficiaries without regard to the growth of the corpus, the court held that investing the entire portfolio in bonds was inappropriate and assessed damages based on the assumption that 50 percent should have been invested in equities. The court upheld a finding by the trial court that the "most accurate rate of appreciation for the determination of ... damages ... would be the rate of appreciation experience[d] by the common equity funds utilized by the [b]ank."[36] The court based this calculation on the fact that the portion of the trust that should have been invested for the benefit of residual beneficiaries would have been invested in the bank's common equity trust fund.

Another example of a court applying a "total return" approach is *First National Bank of Boston v. Truesdale Hospital*,[37] in which the court held that damages attributable to a breach of trust may be reduced or eliminated because of a general pattern of low or negative total return among investments that would have been appropriate. The claimant contended that the bank trustee should have diversified the investments rather than holding only common stock of F. W. Woolworth Company. The claimant alleged that by failing to diversify the investments, the bank trustee should be liable for holding the shares during a falling market. The court held that the failure to diversify violated no duty and caused no damage. The court went on to state:

> that substantially all securities proper for trust investment have fallen in value, and the evidence shows that the common stock of F. W. Woolworth Company has fallen less than most other investment stocks.[38]

The application of the "total return" approach, like the traditional approach, restores the trust estate and its beneficiaries to the position they would have occupied had the trust been properly administered. While such an approach does not insulate trustees from liability during rising markets, it may protect them from unduly harsh treatment in periods of general market decline.

2. Netting Losses Against Gains

The SEC has not established a method for calculating reimbursement amounts for compensable investment adviser errors. Relying on state trust law and the Restatement of Trusts, courts have generally permitted netting gains against losses if (i) an error relates to a single transaction or to a series of closely related transactions or occurrences, and (ii) the investment adviser has acted in

good faith.

Section 101 of the Restatement creates a general presumption against netting, but provides that the amount of a trustee's liability for breach of trust may be reduced if the "acts of misconduct causing the loss and the profit constitute a single breach."[39] Thus, under the Restatement, netting is appropriate where the facts demonstrate that the gains and losses result from one error or a closely related series of errors.[40]

Comment *c* to Section 101 enumerates factors to consider in determining whether the breaches are distinct:

- Whether the improper acts are the result of a single strategy or policy, a single decision or judgment, or set of inter-related decisions;
- The amount of time between the instances of misconduct and whether the trustee was aware of the earlier misconduct and its resulting loss or profit;
- Whether the trustee intended to commit a breach of trust or knew the misconduct was a breach of trust; and
- Whether the profit and loss can be offset without inequitable consequences, for example to beneficiaries having different beneficial interests in the trust.

Courts have permitted netting where the court determined that the error related to a single transaction or a series of transactions that were not viewed as separate and distinct. Not surprisingly, cases that have disallowed netting involved situations where fiduciaries engaged in multiple transactions over longer periods of time. For example, in *State of West Virginia v. Morgan Stanley*, West Virginia's highest court relied on Section 213 of Restatement (Second) to permit netting in connection with a series of unauthorized trades based on the same trading strategy.[41] Similarly, in *Ramsey v. Boatmen's First National Bank of Kansas City*, a Missouri appeals court distinguished between seven improper investments made over a seven year period (for which netting was disallowed) and five improper investments that were made at the same time (for which netting was allowed).[42]

In these cases where netting gains against losses has been allowed, the courts have generally also noted that the investment adviser acted in good faith, or at least that the facts did not demonstrate bad faith. In several of these cases, the court's central focus was on whether the fiduciary acted in good faith.[43]

3. Opportunity Cost

Comment b(1) to Section 100 of the Restatement is also relevant to questions involving the proper measure of damages. Comment b(1) provides that if a trustee improperly purchases investments for a trust estate, the recovery is based in part on the "amount of trust funds expended in the purchase of the improper investments, increased (or decreased) by a projected amount of total return (or negative total return) that would have accrued to the trust and its beneficiaries if the funds had been properly invested." In other words, under certain circumstances, it may be appropriate for a fiduciary to reimburse the beneficiary for losses plus a reasonable measure of the opportunity cost for the misdirected capital. In our experience, while some investment advisers reimburse clients for opportunity costs, this practice is not universal. In addition, we note that there is no SEC guidance requiring such reimbursement.

In other contexts for violations of the federal securities laws, such as Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, federal courts have generally limited recovery to "actual damages" for such claims under Section 10(b) and Rule 10b-5. At least one court has stated that the measure of such damages should be assessed under the "rescission" theory.[44] In its decision, the court crafted a remedy that reduced the plaintiff's "gross economic loss" (measured by a change in the value of the portfolio) by the average percentage decline in the value of:

> the Dow Jones Industrials, Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period commencing with the [improper conduct].[45]

This modification of the "rescission" theory of damages compensated the investor without placing him in a better position than he would

have been in if the fraud had not occurred. The court stated:

> Rolf's portfolio, even if it had not been fraudulently mismanaged, would have declined in value during the bear market of the aiding and abetting period. [Defendants] have no responsibility for the general decline in economic conditions. The rescission theory of damages which we essentially utilize here cannot restore a plaintiff to a better position than he would have been in if the fraud had not occurred.[46]

Similarly, in *Miley v. Oppenheimer & Co. Inc.,*[47] the court appears to adopt a "rescission" theory of damages, without explicitly stating it. The court noted the "difficulty in accurately measuring the loss in portfolio value proximately caused by the excessive trading and unsuitable transactions," as well as the impossibility of computing "the exact amount of trading losses caused by the churning of an account."[48] The court nevertheless held the plaintiff to be "entitled to recover the difference between what he would have had if the account ha[d] been handled legitimately and what he in fact had at the time the violation ended."[49] The court upheld the trial court's jury charge requiring the computation of the damages sustained by plaintiff by ascertaining the amount of her original investment and subsequent dividends thereon, subtracting therefrom any withdrawals received by her and the ending value of her account with the broker, and further subtracting "the average percentage decline in value of the Dow Jones Industrials or the Standard and Poor's Index during the relevant period of time."[50]

4. Other Possible Methods for Calculating Damages

As discussed above, an investment adviser can look to different reference investments to assist in determining a client's loss due to an error. Although there is no express guidance from the SEC with respect to the use of account performance or the performance of alternative investments in calculating damages, we believe that an investment adviser could reasonably use one of these methods to determine a client's loss under the "total return" approach.

a. Account Performance

An investment adviser could calculate damages by comparing the performance of the account during the period when the account was improperly invested to the performance of the account without such investment during the same period. If the performance of the account as a whole is greater than the performance of the improper investment, the account may be reimbursed in order to place the account in the same position it would have been had the improper investment not been made. If the performance of the account as a whole, however, is lower than the performance of the improper investment, reimbursement may not be required since the account would be in a better economic position than it would have been had the improper investment not been made.

b. Alternative Investments

Another approach is to compare the performance of the account during the period when the account was improperly invested to the performance of the account if the assets had been invested in an appropriate alternative investment. This approach considers what the account's performance likely would have been if the assets used to purchase the improper investment had instead been invested in an alternative investment consistent with the account's investment guidelines. Depending on the investment adviser's strategy, such investment may be a similar security, index (or sub-index) or basket of securities. If the performance of the account during the time period the account held the improper investment is worse than the performance of the account had the assets been invested in the alternative investment, the investment adviser may need to reimburse the account. However, if the performance of the account during the time period the account held the improper investment was better than the performance of the account had the assets been invested in the alternative investment, reimbursement may

not be necessary, because in this circumstance, the account is in a better economic position than it would have been had the violating security not been purchased.

II. Conclusion

While no investment adviser wishes to be faced with circumstances involving errors in its client accounts, an investment adviser can prepare to address such errors by carefully reviewing the standards of care set forth in its client agreements. Adopting error correction guidelines that provide a framework for considering the standard of care, whether a breach of such standard has occurred and how, in the event of a breach, the investment adviser will approach the question of potentially reimbursing client accounts, will also facilitate an investment adviser's analysis and ultimate decision on how to respond should an error occur.

Notes

1. In its release adopting Rule 206(4)-7, the SEC does not specifically discuss investment errors or error correction policies, although such policies would arguably be part of policies necessary to address:

> [p]ortfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser, and applicable regulatory restrictions; [or]
>
> [t]rading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients.

Compliance Programs of Investment Companies and Investment Advisers, Rel. No. IA-2204 (Dec. 13, 2003) (Compliance Program Adopting Release).

2. *See, e.g.*, *In the Matter of Michael T. Jackson and EMG Capital,* Rel. No. IA-2374 (Apr. 6, 2005).

3. While an investment error may result in a pricing or net asset value (NAV) error, such errors are generally outside the scope of this article. With respect to clients that are investment companies, informal SEC Staff guidance suggests that investment advisers have an obligation to correct material pricing errors. *See* Investment Company Institute, "Valuation and Liquidity Issues for Mutual Funds" (Feb. 1997) (ICI Valuation Paper). There is no official SEC or SEC Staff guidance on what constitutes a "material" NAV error, although for purposes of valuation errors, a two-step approach has been suggested by the SEC Staff. *See* ICI Valuation Paper. At the fund level, a pricing error is deemed "material" if it is more than one cent per share on a given day. At the shareholder level, an error is "material" if it is more than 1/2 of 1% of the fund's NAV and requires reprocessing of the transaction to compensate the shareholders for any loss.

4. One no action letter includes the following examples in describing a firm's trading errors:

> 1) the purchase or sale of the wrong security (e.g., common stock of AT&T, instead of IT&T); 2) the purchase or sale of an incorrect amount of shares of a security; 3) the purchase or sale of a security at a price not in accordance with instructions; or (4) a purchase of a security when the intent was to sell, or vice versa.

Charles Lerner, SEC No-Action Letter (pub. avail. Oct. 25, 1988) (hereinafter *Lerner*).

5. An investment adviser may not be liable for losses that result from a third party's improper conduct. *See* RESTATEMENT (THIRD) OF TRUSTS § 80, cmt. g (2008) (a trustee who acts with prudence in delegating to an agent is not personally liable to the trust or beneficiaries for the decisions or actions of the agent to whom the function is delegated). *See also* Matter of Smith, 266 N.Y.S. 666 (Surr. Ct. 1933) (executor employed an accountant whose negligence caused penalties for late payments; trustee was not liable).

6. As discussed below, the question of whether a breach of trust has occurred in connection with the investment of the assets of the trust generally turns on the prudence of the fiduciary's conduct rather than the results of the investment decisions. *See* RESTATEMENT (THIRD) OF TRUSTS § 90, cmt. b (2008) ("A trustee is not a guarantor of the trust's performance.")

7. 15 U.S.C. § 80b-6(1), (2), (4).

8. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 189-191 (1963).

9. *Id.*

10. A "hedge clause" is generally defined to mean a statement made to free oneself from responsibility.

11. Auchincloss & Lawrence, SEC No-Action Letter (pub. avail., Feb. 6, 1974) (hereinafter *Auchincloss*).

12. *Id.*

13. *Id.*, stating: "Except for negligence or malfeasance, or violation of applicable law, neither you nor any of your officers, directors or employees shall be liable here under for any action performed or omitted to be performed or for any errors of judgment in managing the Account. The federal securities laws impose liabilities under certain circumstances on persons who act in good faith, and therefore nothing herein shall in any way constitute a waiver or limitation of any rights which the undersigned may have under any federal securities laws."

14. *See*, *e.g.*, Omni Management Corporation, SEC No-Action Letter (pub. avail. Dec. 13, 1974) (suggesting that references to "gross" negligence or malfeasance be deleted and that a reference to state law be added to the non-waiver proviso); First National Bank of Akron, SEC No-Action Letter (pub. avail. Feb. 27, 1976) (expressing the view that if the "hedge clause purports to limit liability to acts done in bad faith or to willful misconduct 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").

15. Heitman Capital Management, LLC, SEC No-Action Letter (pub. avail., Feb. 12 2007).

16. 15 U.S.C. § 80a-17(i).

17. *Lerner*, *supra* n.4 (an investment adviser "is responsible for losses from an inaccurate or erroneous order placed for an advised account").

18. *Id*.

19. The SEC has sanctioned investment advisers and their associated persons for failure to prevent and detect trading errors. Each of these cases, however, involved special circumstances or egregious behavior. *See*, *e.g.*, *In re Rhumbline Advisers*, Rel. No. IA-1765 (Sept. 29, 1998) (failing to implement any procedures to monitor trading); *In re First Capital Strategies,* Rel. No. IA-1648 (Aug. 13, 1997) (failing to implement controls to ensure compliance with investment guidelines and misrepresenting the existence of such controls); *In re M&I Inv. Mgmt Corp.,* Rel. No. IA-1318 (Jun. 30, 1992) (undertaking improper affiliated transactions either to correct or hide the error); *In re Jack Allen Pirrie*, Rel. No. IA-1284 (Jul. 29, 1991) (failing to inform clients of trade errors and using clients' soft dollar credits to absorb the adviser's loss); and *In re Shearson Lehman Brothers Inc.*, Rel. No. IA-1038 (Sep. 24, 1986) (fraudulent schemes involving unauthorized trades). Absent special facts, we think it is unlikely that an investment error would necessarily lead to an SEC enforcement action.

20. A longstanding Massachusetts decision describes gross negligence as "substantially and appreciably higher in magnitude than ordinary negligence," "materially more want of care than constitutes simple inadvertence," and "an act or omission respecting legal duty of an aggravated character as distinguished from a mere failure to exercise ordinary care. It is very great negligence, or the absence of slight diligence, or the want of even scant care." Altman v. Aronson, 231 Mass. 588, 591 (1919). A number of other courts, including those in Delaware and New York, have embraced similar views.

21. *See, e.g.,* Jones v. Harris Assoc. L.P., 527 F.3d 627 (7th Cir. 2008) (noting that, in interpreting the fiduciary duty owed under Section 36(b) of the 1940 Act, it is appropriate to "summon up the law of trusts").

22. *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 76 (2008). For example, while a trustee ordinarily is liable for failure to deliver trust property to its proper distributee, it is not liable when a misdelivery results from information the trustee was unable to obtain despite diligent, good-faith efforts. *Id.* § 76, cmt. f.

23. Scott & Ascher on Trusts (Fifth Edition) §19.1.2, note 15 (noting that almost all states have adopted the Uniform Prudent Investor Act of 1994). *See*, *e.g.*, Mass. Gen. Laws Ch. 203C §§ 1-11 (modified version); N.Y. Est. Powers & Trust Law § 11-2.3. Delaware has statutory provisions that incorporate features of the UPIA. *See* Del. Code. Ann. Ch. 12 § 3302.

24. In essence, this is the standard that is contemplated by Rule 38a-1 under the 1940 Act for compliance programs that "are reasonably designed to prevent violations of the Federal Securities Laws." 17 C.F.R. § 270.38a-1.

25. Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies Inc., 854 A.2d 121 (Del. Ch. 2004) (*citing* Zirn v. VLI Corp., 681 A.2d 1050 (Del. 1996), for the proposition that a beneficiary may, by contract, insulate a fiduciary from liability for a breach of the duty of care, including one related to disclosure). In *Zirn*, the court held that damages could not be obtained for an alleged breach of fiduciary duty in the case of a good faith erroneous judgment as to the proper scope or content of required disclosure, whether on theory of equitable fraud or breach of fiduciary duty of care, where corporation had an exculpatory charter provision.

26. *See*, *e.g.*, Stark v. U.S. Trust Company of New York, 445 F. Supp. 670, 678-680 (1978). *See also* RESTATEMENT (THIRD) OF TRUSTS § 90, cmt. b (2008) ("The question of whether a breach of trust occurred turns on the prudence and propriety of the trustee's conduct, not on the eventual results of investment decisions.").

27. In addition, federal courts have considered how to determine damages in other contexts for violations of the federal securities laws, generally limiting recovery to actual damages. *See, e.g.*, Randall v. Loftsgaarden, 478 U.S. 647, 656 (1986) (stating that a rescissory measure of damages involves a return of the consideration paid, reduced by the amount realized when the security is sold, and by any income received on the security).

28. *See* RESTATEMENT (THIRD) OF TRUSTS § 100 (2012). *See also* Scott and Ascher on Trusts, § 24.9 (the trustee is liable for the "amount required to restore the values of the trust estate and trust distributions to what they would have been if the trust had been properly administered.").

29. RESTATEMENT (THIRD) OF TRUSTS § 100 (2012).

30. *See, e.g.,* Elliott v. Sparrell, 114 Mass. 404 (1874); Lannin v. Buckley, 256 Mass. 78, 81 (1926).

31. *See, e.g.,* In re Dickinson, 152 Mass. 184 (1890); Chase v. Pevear, 383 Mass. 350 (1981) (for a modern application of surcharging a trustee for making improper investments).

32. *See e.g.*, Mass. Gen. Laws. Ann. ch. 203C, § 2 (2011).

33. RESTATEMENT (THIRD) OF TRUSTS, § 100, cmt. b(1) (2012). The comment goes on to suggest that a return projection for "properly invested" funds should reflect the

standards of prudent investment in § 90(a), and should not rely on hindsight in selecting a benchmark for hypothetical performance. Comment *a* to Section 100 also permits the beneficiary to ratify the transaction or simply take no action regarding the trustee's possible misconduct. Comment b(1) acknowledges, however, that in breaches of short duration or relatively minor details of loss measurement, compound interest rather than total-return projections may be appropriate in determining the amount of loss to be recovered from a trustee.

34. RESTATEMENT (THIRD) OF TRUSTS, § 100, cmt. *b(1)* (2012).

35. Noggle v. Bank of America NT & SA, 70 Cal. App.4th 853 (1999).

36. *Id.* at 862.

37. 192 N. E. 150 (Mass. 1934).

38. *Id*. at 154.

39. RESTATEMENT (THIRD) OF TRUSTS (2012), § 101. The rule of this Section essentially continues the rule of prior Restatements. *See* RESTATEMENT (THIRD) OF TRUSTS, (Prudent Investor Rule) § 213 (1992) and its commentary, which sought to clarify and modernize the commentary of RESTATEMENT (SECOND) OF TRUSTS § 213.

40. Comment *a* of § 101 makes clear that a fiduciary may not balance losses attributable to a breach of trust against gains attributable to actions that do not involve a breach of trust and similar language in Section 213 of Restatement (Second) has been cited by courts in support of prohibiting the netting of certain losses. *See, e.g.,* Cal. Ironworkers Field Pension Trust v. Loomis Sayles & Co., 259 F.3d 1036, 1047-48 (9th Cir. 2001) and Donovan v. Bierwirth, 754 F.2d 1049, 1054 (2d Cir. 1985).

41. 194 W.Va. 163 (W.Va. 1995).

42. 914 S.W.2d. 384 (Mo. Ct. App. W.D. 1996).

43. Contract law principles also would support netting. It is a recognized principle of contract law that a defendant in an action for breach is entitled to show any matters which go to reduce the amount of loss actually suffered by plaintiff, provided such matters have a proximate relation to the contract. 25 C.J.S. "Damages," Section 97. Vitagraph, Inc. v. Park Theatre Co., 249 Mass. 25, 144 N.E. 85 (1924).

44. Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38 (2nd Cir.), cert. denied, 439 U.S. 1039 (1978).

45. *Id.* at 49.

46. *Id.* *See also* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1304-06 (2d Cir. 1973); Feit v. Leasco Data Processing Equipment Corp., 332 F.Supp. 544, 586 (1971) (reducing trading losses by decline in the Standard & Poor's Daily Stock Price Index).

47. 637 F. 2d 318, 327 (5th Cir. 1981).

48. *Id.* at 327.

49. *Id.*

50. *Id.* at 328.

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