SEC PUBLISHES A ROADMAP TO NAVIGATING THE INVESTMENT ADVISER FIDUCIARY DUTY

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U.S. Investment Management Alert

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On June 5, 2019, the U.S. Securities and Exchange Commission (the "SEC") adopted a final interpretation (the "Interpretation") of the standard of conduct applicable to investment advisers ("IA") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). [1] The Interpretation applies to both SEC- and state-registered IAs, as well as IAs that are exempt or prohibited from SEC registration. The Interpretation is generally consistent with the proposed version published on April 18, 2018; [2] however, the revised Interpretation includes enhanced discussion of the application of the standard of conduct to institutional clients. This enhanced discussion represents a more complete analysis from the initial proposal, which focused almost exclusively on retail clients. The Interpretation will become effective upon publication in the Federal Register.

The Interpretation does not purport to modify the existing IA standard of conduct, but rather to reaffirm and clarify the SEC's view with respect to certain aspects of the existing standard. Nevertheless, and as discussed below in "*Practical Considerations*," IAs should consider reviewing their existing policies and procedures and their Form ADV Part 2A disclosures, particularly those addressing conflicts and trading, as well as their forms of investment advisory agreements, their private fund offering documents, and existing client agreements, to confirm they are consistent with the Interpretation. In certain cases, IAs may consider adopting new policies, such as monitoring policies, for advisory services provided to retail clients.

I. THE INVESTMENT ADVISER'S FIDUCIARY DUTY

The application of the fiduciary duty imposed under the Advisers Act is principles-based, meaning that the standard of conduct is not based on a set of statutory or regulatory prescriptions. Rather, it is based on equitable common law principles fundamental to a relationship of trust and confidence between an adviser and its client. [3] In issuing the Interpretation, the SEC voted to retain this principles-based application (rather than adopting a rule) and to reaffirm the fact that, in its view, IAs have a fiduciary duty to their clients enforceable under the anti-fraud provisions of the Advisers Act.

The absence of a specific statute or regulation specifying the fiduciary duty requirements has allowed for the scope of the duty to be established over time through interpretation by the U.S. Courts [4] and interpretation by the SEC and its staff through enforcement actions, no-action letters and other guidance. [5] Moreover, depending on the nature of the services defining a client relationship, advisers are able to shape the scope of the fiduciary

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duty by contract with their clients. Regardless of how the fiduciary duty between an IA and a particular client is tailored, the Interpretation reaffirms that an IA's fiduciary duty applies to all investment advice provided to a client, including advice about investment strategies, engaging a sub-adviser, and account type (*e.g.*, whether to open or invest through a certain type of account).

Consistent with longstanding equity common law principles, an IA's fiduciary duty is comprised of two distinct duties: (i) the duty of care; and (ii) the duty of loyalty. The overarching principle that encompasses both of these duties is the IA's obligation to serve the best interest of the client and to not subordinate the client's interest in favor of the IA's own interest. Breaking it down, under the Interpretation: (i) the duty of care requires an IA to have a reasonable belief that the advice it provides is in the best interest of a particular client, based on the client's investment objectives; and (ii) the duty of loyalty requires an IA to either eliminate ***or*** make full and fair disclosure of all conflicts of interest that might incline an IA (unconsciously or consciously) to render advice that is not disinterested. The importance of full and fair disclosure of conflicts is to enable a client to make informed consent regarding the conflict. The Interpretation does not change this.

The adoption of the Interpretation was not unanimous, and was not without criticism from within the SEC. Both Commissioner Jackson [6] and the SEC's Investor Advocate [7] both expressed concern that the Interpretation did not go far enough and may have lowered expectations for investment advisers in certain circumstances. In particular, Commissioner Jackson noted that the Interpretation removed the language in the proposal that the law "requires an investment adviser to put its client's interests first." In the Interpretation, the SEC notes that "referring to putting a client's interest first is a plain English formulation commonly used by investment advisers to explain their duty of loyalty in a way that may be more understandable to retail clients" but that the Interpretation revises the description of the duty of loyalty to be "more consistent with how [the SEC] previously described the duty." In addition, the Investor Advocate noted that under the Interpretation liability for nearly all conflicts can be avoided through disclosure, whereas the Investor Advocate believes that an IA's duty requires both disclosure ***and*** conflict avoidance.

In adopting the Interpretation and the related actions, the SEC acknowledged that the Interpretation may not be the last word on what constitutes an IA's standard of conduct. In fact, Commissioner Jackson all but invited states to adopt their own separate standards in an impassioned dissent to the adoption of package of proposals. A little more than one week after the SEC adopted the Interpretation, the Commonwealth of Massachusetts, Securities Division issued a preliminary solicitation for public comments related to fiduciary conduct standards for broker-dealers, sales agents, investment advisers, and investment adviser representatives [8] and other states have indicated an intention to take similar action. Moreover, the U.S. Department of Labor has indicated its intention to issue proposed rulemaking with respect to a Fiduciary Rule and Prohibited Transaction Exemptions in December 2019. [9] It remains to be seen how these additional rulemakings will impact the ongoing standard of conduct for IAs.

II. NO WAIVER OF FIDUCIARY DUTY

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The Interpretation reaffirms the SEC's longstanding belief that an IA's fiduciary duty may not be waived. Notably, the SEC identified disclaimers of fiduciary status, blanket waivers of conflicts of interests and waivers of specific obligations under the Advisers Act as inconsistent with the Advisers Act for all types of clients. However, the scope of the fiduciary duty as applied to a particular IA-client relationship may be shaped and altered by the underlying advisory agreement, provided the client has received full and fair disclosure addressing how the duty has been tailored and has given informed consent. The specific obligations that flow from each of the duty of care and the duty of loyalty will depend on what services the IA has agreed to provide to the client.

The Interpretation also withdraws no-action relief issued by the SEC in 2007 that market professionals interpreted as an expansion of the ability of IAs providing advisory services to institutional investors to disclaim their fiduciary duties under state law and in the advisory agreement. [10] Guidance in the Interpretation clarifies that the fiduciary duty may not be disclaimed, although it may be shaped as discussed above. Moreover, while acknowledging that the validity of a clause in an advisory agreement purporting to limit an IA's liability under the agreement (*i.e.*, a "hedge clause") is a facts and circumstances test, a hedge clause is likely to mislead retail clients into not exercising their legal rights against an IA for breach of its fiduciary duty in violation of the Advisers Act, and as such the SEC does not see any facts and circumstances where it would be appropriate in a retail context. However, depending on the facts and circumstances of an IA's relationship with an institutional client, the Interpretation states that an IA may include hedge clauses in institutional advisory agreements.

III. COMPONENTS OF THE FIDUCIARY DUTY

a. Duty of Care

The Interpretation states that duty of care includes, among other things, three specific duties: (i) the duty to provide advice that is in the client's best interest; (ii) the duty to seek best execution; and (iii) the duty to provide advice and monitoring over the course of the relationship.

i. Duty to act in the best interest of the client

The duty to provide investment advice that is in the best interest of the client, based on a reasonable understanding of the client's investment objectives, includes a duty to provide advice that is suitable for the client. This obligation requires IAs to not only engage in a reasonable inquiry to determine information pertinent to the client's objectives and risk tolerance, but also to conduct a reasonable investigation into the suitability of the investment itself. The IA's investigation of the investment must be thorough enough for the IA to conclude it is not basing advice on materially inaccurate or incomplete information. As discussed under "*Practical Considerations*" below, however, the scope of this duty, and the level of inquiry, varies depending on the nature of the client (*i.e.*,

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retail or institutional.)

ii. Duty to seek best execution

The duty to seek best execution applies where the IA is responsible for selecting broker-dealers to execute client trades. Generally, the IA should seek to maximize value for each client under the particular circumstances occurring at the time of the transaction, and should "periodically and systematically" evaluate execution quality over time. The SEC clarifies in the Interpretation that "maximizing value" encompasses more than simply minimizing costs. IAs should consider the "full range and quality" of a broker's services, which may include the value of research provided, execution capability, commission rate, financial responsibility, and responsiveness to the IA. Accordingly, the determinative factor in deciding if the IA has fulfilled its duty to seek best execution is not whether the client paid the lowest possible commission or other transaction cost, but "whether the transaction represents the best qualitative execution."

iii. Duty to provide advice and monitoring over the course of the relationship

In order to fulfill the duty of care, IAs must provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship. Generally, the duty to monitor extends to all personalized advice the IA provides to a client, including, with respect to ongoing relationships, an evaluation of whether a client's account or program type continues to be in the client's best interest. However, the Interpretation explains that, absent any agreed limitation or expansion, the scope of the duty to monitor will be determined based on the duration and nature of the agreed-upon services expressed in the advisory agreement. Generally, therefore, short duration agreements, including agreements with respect to a single delivery of services, such as a financial plan for a one-time fee, are unlikely to carry a duty to monitor.

b. Duty of Loyalty

The duty of loyalty prohibits an IA from subordinating its clients' interests to its own and applies not just to advice regarding potential investments, but to all advice the IA provides to an existing client. This duty encompasses advice about investment strategy, engaging a sub-adviser, and account type.

To meet the duty of loyalty, IAs must provide clients with full and fair disclosure of all material facts relating to the advisory relationship, including the capacity in which the firm is acting with respect to the advice provided. Full and fair disclosure of a conflict of interest should put a client in a position to understand and provide either explicit or implicit informed consent to the conflict. Full and fair disclosure or informed consent is not required to be in a written agreement. For example, an SEC-registered IA could provide a client full and fair disclosure through delivery of Part 2A of Form ADV, and the client could implicitly consent by entering into or continuing the investment advisory relationship with the IA following receipt of the Form ADV. However, an IA cannot infer or accept client consent where the IA is aware, or reasonably should be aware, that the client did not understand the

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nature and importance of the conflict.

i. Specificity required in full and fair disclosure

"Full and fair disclosure" must be sufficiently specific to permit a client to understand the material facts or conflict of interest and make an informed decision whether to provide consent. For example, full and fair disclosure referencing "other clients" must describe how the IA will manage conflicts between clients if and when they arise. Similarly, an IA should not merely disclose that it has "conflicts" without a description of those conflicts.

The Interpretation also discusses the appropriateness of disclosing that an IA "may" have a conflict. Generally, the SEC's view is that the term "may" should not be used where a conflict actually exists. Further, the term "may" should be avoided if the term simply precedes a list of all possible or potential conflicts regardless of the likelihood any conflict will arise. In contrast, the use of "may" is appropriate to disclose to a client a potential conflict that does not currently exist, but might reasonably present itself in the future.

ii. Considerations for disclosure regarding allocation of investment opportunities

The obligation to, at a minimum, provide full and fair disclosure to clients regarding conflicts with respect to investment allocations does not require IAs to impose a *pro rata* allocation policy. Instead, an IA may consider the nature and objectives of a client and the scope of the advisory relationship when allocating investment opportunities. So long as a client provides informed consent, an IA may agree with a client that certain opportunities will not be allocated or offered to the client.

IV. PRACTICAL CONSIDERATIONS

As discussed in detail below, the application of the various elements of an IA's fiduciary duty may differ depending on the nature of the client relationship. The SEC discussed and provided examples of many of these differences in the Interpretation. We discuss certain of the most notable below.

a. Thinking about the Duty of Care based on the Client

i. Retail Clients

The duty of care as applied to retail clients requires an IA to engage in a reasonable inquiry of the retail client's

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financial situation, level of financial sophistication, investment experience, and financial goals (collectively, the "Investment Profile"). In addition, IAs advising retail clients must periodically update the Investment Profile, even if updating is not expressly included as a service in the advisory agreement. In the SEC's view, updating the Investment Profile is necessary for an IA to maintain a reasonable understanding of the retail client's objectives and to permit the IA to adjust its advice to reflect changed circumstances. The frequency with which the Investment Profile must be updated is not mandated, but instead should be determined based on the facts and circumstances of each client. For instance, if the IA has actual knowledge of a shift in the retail client's financial situation, the Investment Profile should be updated. Similarly, an IA providing one-time investment advice to a retail client likely may have no obligation to update the Investment Profile.

ii. Institutional Clients

In contrast, the obligation that IAs have a reasonable understanding of a client's objectives requires IAs advising institutional clients to have a reasonable understanding of the institutional client's investment mandate. To fulfill this obligation, the IA must pay particular attention to the specifics of the investment mandate itself. For instance, an IA engaged to advise on an institutional client's investment grade bond portfolio is not obligated to gain a reasonable understanding of the client's objectives within the client's entire investment portfolio. The IA will meet its obligation after gaining a reasonable understanding of the institutional client's objectives solely within the investment grade bond portfolio. For IAs to private funds, the client is the fund itself, and not the underlying investors in the fund. Accordingly, the requirement to understand the client's investment mandate relates to the fund's investment strategy, as disclosed in the fund's offering documents. In managing the fund, the IA is not required to consider the investment objectives of investors in the fund.

In addition, unlike for retail clients, there is generally no duty to update an institutional client's investment mandate, unless otherwise required in the advisory agreement. This is especially true where the institutional client is a private fund.

b. Thinking about the Duty of Loyalty based on the Client

i. Retail Clients

The obligation to either eliminate or expose any conflicts of interest with full and fair disclosure may prove a difficult task for IAs advising retail clients potentially having less sophistication than institutional clients. The Interpretation identifies conflicts of a complex or extensive nature as not readily subject to full and fair disclosure to enable a retail client to understand them for purposes of providing informed consent. Thus, for conflicts that cannot easily be fully and fairly disclosed, or understood even if disclosed, the IA should either eliminate or mitigate them to then enable full and fair disclosure and informed consent.

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ii. Institutional Clients

IAs advising institutional clients are subject to the same requirement to either eliminate or expose any conflicts of interest with full and fair disclosure. Institutional clients should generally be more sophisticated and have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications. Accordingly, the full and fair disclosure required for an institutional client may differ, in some cases significantly, from the full and fair disclosure required for a retail client.

c. Thinking about the Fiduciary Duty for Dual Registrants

When an individual acts as both an associated person of a broker-dealer and a supervised person of an IA, or when a firm is dually registered as a broker-dealer and an IA, the Interpretation provides particular guidance regarding compliance with the IA fiduciary duty.

i. Duty of Care

The obligation to give advice that is in the best interest of the client extends to selection of the account type that will best assist the client in meeting his, her or its investment objectives. Individuals or firms who are dually licensed should consider all types of accounts when determining whether selection of a particular account type is in a client's best interest. Accordingly, such dually licensed persons should consider both brokerage accounts and advisory accounts when assisting clients in selecting an account type.

ii. Duty of Loyalty

The obligation under the duty of loyalty to fully and fairly disclose all material facts relating to the advisory relationship is particularly relevant for firms or individuals that are dually licensed and serve the same client in each capacity. In such a situation, IAs should disclose the circumstances in which they intend to act in a brokerage capacity and the circumstances in which they intend to act in their advisory capacity. When acting in an advisory capacity, the IA should disclose any circumstances under which its advice will be limited to a menu of certain products offered through its affiliated broker-dealer or affiliated IA.

d. Other General Considerations for IAs

i. Reviewing and Updating Existing Policies and Procedures

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Generally, IAs maintain policies and procedures that set forth the required processes by which the IA may act. They may address conflicts of interest, allocation of investment opportunities, best execution determinations, and overall trading requirements. IAs may wish to review these policies and procedures with the Interpretation in mind to confirm they align with the Interpretation.

In particular, the Interpretation states that an IA should periodically and systematically evaluate the execution received for its clients. In addition, if an IA is using an affiliated broker to execute client trades, the conflict of interest must be fully and fairly disclosed to the client, and the client must provide informed consent to the conflict. IAs may wish to confirm that their existing best execution policies and procedures provide for these processes and, if they do not, amend the policies and procedures to comply.

ii. Adoption of New Policies and Procedures

IAs should consider putting into place policies and procedures addressing processes that IAs may already be performing but that have not been formally documented. For instance, many IAs already perform some sort of monitoring over the course of an ongoing client relationship. IAs should consider (i) whether the current monitoring process aligns with the guidance provided in the Interpretation, and (ii) documenting the monitoring process in written policies and procedures and/or as an express service under the advisory agreement.

IAs should similarly consider reviewing their existing disclosures (whether in Part 2A of their Form ADVs or otherwise) to confirm they include "full and fair" disclosures as described in the Interpretation. This is particularly important for IAs to closed-end private funds, where the SEC has in recent years broadened enforcement activity and narrowed the opportunity for managers to correct past deficiencies regarding their disclosure of conflicts. [11]

iii. Reviewing and Updating Template Investment Advisory Agreements

IAs should consider reviewing their forms of investment advisory agreements, and existing client agreements, to confirm that as currently drafted they adhere to the guidance set forth in the Interpretation. Given the focus on full and fair disclosure and informed consent in the Interpretation, IAs should consider modifying the standard representation generally included in investment advisory agreements with respect to Form ADV so that the representation (i) contains an acknowledgement from the client that the client read and understood the Form ADV, including any conflicts disclosed, (ii) includes the client's acknowledgement that the client has consented to the conflicts, and (iii) states that conflicts disclosed in the Form ADV from time to time and consented to by the client will be incorporated by reference into the investment advisory agreement. In addition, IAs should review any provisions limiting the IA's liability to confirm these provisions are consistent with the Interpretation's clarifications regarding the use of hedge clauses. With respect to investment advisory agreements intended for use with retail clients, beginning June 30, 2020 (the effective date of Form CRS) IAs should consider adding an express

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acknowledgement that the retail client received and understood the IA's Form CRS. [12] IAs serving retail customers should also consider updating their retail investment advisory agreements to include a provision setting forth the frequency of the monitoring that the IA will perform (*e.g.*, quarterly or annually). In absence of such an express provision, the SEC may interpret the obligation as one that is ongoing and without any limitations.

With respect to investment advisory agreements intended for use with institutional customers, IAs should consider modifying their forms of agreement and amending existing agreements to confirm that the institutional client's investment mandate is documented with sufficient specificity for the IA to understand the mandate, and appropriately sets forth whether the IA has an obligation to monitor and recommend suggested changes to the mandate.

NOTES

[1] Investment Advisers Act Release No. 5248, 17 CFR Part 276 (June 5, 2019).

[2] Investment Advisers Act Release No. 4889 (April 18, 2018), 83 F.R. 21203 (May 9, 2018).

[3] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

[4] *See* id.; *see also* SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008); SEC v. Moran, 944 F. Supp. 286, 297 (S.D.N.Y. 1996).

[5] *See* In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948); Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010); Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406 (Mar. 16, 1994); Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 28, 1986).

[6] Statement on Final Rules Governing Investment Advice, Commissioner Robert L. Jackson, U.S. Securities and Exchange Commission, June 5, 2019 (available at https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd).

[7] Statement Regarding the SEC's Rulemaking Package for Investment Advisers and Broker-Dealers,Investor Advocate, U.S. Securities and Exchange Commission, June 5, 2019 (available at https://www.sec.gov/news/public-statement/statement-regarding-sec-rulemaking-package-investment-advisers-broker-dealers).

[8] U.S. Department of Labor, Fiduciary Rule and Prohibited Transaction Exceptions, status found at: http://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryconductstandardidx.htm.

[9] Commonwealth of Massachusetts, Securities Division, Preliminary Solicitation of Public Comments: Fiduciary Conduct Standard for Broker-Dealers, Agents, Investment Advisers, and Investment Adviser Representatives, found at: https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=1210-AB82.

[10] Heitman Capital Management, LLC, SEC Staff No-Action Letter (Feb. 12, 2007).

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[11] Full disclosure to limited partner advisory committees and other limited partner representatives of a manager's fee practices allow these groups to manage ongoing conflicts between a fund and its IA, but whether disclosure of a conflict was sufficient to allow an investor to make an informed decision to subscribe to a fund will necessarily depend on the disclosure that was made to the investor at the time of the investment.

[12] Investment Advisers Act Release No. 5247, 17 CFR Parts 200, 240, 249, 275, and 297 (June 5, 2019).

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