Clients&FriendsMemo

Commission Interpretation – Standard of Conduct for Investment Advisers

July 1, 2019

The Securities and Exchange Commission (the "SEC") on June 5, 2019 released an interpretation of the standard of conduct required by the Investment Advisers Act of 1940 (the "Advisers Act") of investment advisers as fiduciaries to their clients.[1] The Release affirmed the SEC's long–standing view that the scope of an adviser's obligations must be based on overarching principles, as opposed to a laundry list of specific obligations. However, the Release does provide some useful examples of the application of an adviser's fiduciary duty obligations to its clients, and additional information as to the SEC's view of what constitutes full and fair disclosure by an adviser of its conflicts and informed consent to those conflicts by a client.

The Release purports not to create any new legal obligations for advisers, and thus to be only an "interpretation" and not a rulemaking. The Release does not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law, nor does it address the extent to which the Advisers Act applies to impersonal investment advice.

I. Best Interest is Combination of Care and Loyalty

According to the SEC, an investment adviser's fiduciary obligation to act in the best interest of its client encompasses both the duty of care and duty of loyalty. The duty of care requires an investment adviser to provide investment advice and take actions that are in the best interest of the client, while the duty of loyalty requires an investment adviser to "eliminate or make full and fair disclosure of all conflicts of

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[1] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019) ("the Release").

The Interpretation was one of a set of four releases relating to the standard of conduct required of broker-dealers and investment advisers. The other releases are: Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 (June 5, 2019); Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Investment Advisers Act Release No. 5247 (June 5, 2019); Fiduciary Interpretation; Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion to the Definition of Investment Adviser, Advisers Act Release No. 5249 (June 5, 2019).

interest which might incline an investment adviser … consciously or unconsciously … to render advice which was not disinterested."[2]

Interestingly, in response to the proposed interpretation, one commenter questioned whether there is much support for the conclusion that a duty of care obligation actually exists.[3] Not surprisingly, the SEC disagreed, and asserted the view that the duty of care requires an investment adviser to "provide investment advice in the best interest of its client, based on the client's objectives."[4] (While the argument that advisers do not have a duty of care was never going to be accepted by the SEC, there is actually surprisingly little, if anything, in the way of regulatory enforcement actions as to the duty of care imposed on an adviser. The regulatory enforcement actions are almost entirely on the duty of loyalty and failures to make adequate disclosures.)

The SEC also affirmed that an adviser's fiduciary duty applies to all investment advice the adviser provides to clients, including advice about investment strategy, engaging a sub-adviser, and appropriate account type."[5]

II. Contract with Client

The relationship between an investment adviser and its client may be shaped by contract, so long as there is full and fair disclosure and informed consent and subject to certain further constraints. An investment adviser must consider whether the client is retail or institutional when negotiating its agreement with a client. An adviser's obligations when agreeing to terms with a retail client may differ from that of an adviser to a registered investment company or private fund.

As to specific provisions that may be included in a client agreement, the Release states that an adviser's "fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the relationship."[6] The SEC also provided three specific examples of unacceptable waivers: (i) that the adviser will not act as a fiduciary, (ii) a waiver of all conflicts of interest, and (iii) a waiver of any specific obligation under the Advisers Act.[7]

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[2] The Release at page 6.

[3] *See* Comment Letter of Dechert LLP (Aug. 7, 2018) (citing the absence of a single federal case holding that the Advisers Act imposes a "duty of care" and pointing out that the cited administrative proceedings base their holdings on a failure to adequately disclose rather than a "duty of care").

[4] The Release at page 8.

[5] Consistent with Reg BI, the Release clarified that account type clearly includes "advice about whether to roll over assets from one account (*e.g.*, a retirement account) into a new or existing account that the adviser or an affiliate of the adviser manages; Release at page 18 (stating an adviser's duty to monitor extends to all personalized advice it provides to the client, including an evaluation of whether a client's account or program type continues to be in the client's best interest).

[6] The Release at page 10.

[7] The Release at pages 10-11.

The SEC also clarified its view as to the use of "hedge clauses" in advisory agreements. (A hedge clause is a provision added to an investment advisory contract or agreement which typically discharges the adviser from liability unless the adviser has been grossly negligent or has engaged in reckless or willful misconduct, illegal acts, or acts outside the scope of its authority.[8]) The SEC stated that, while a hedge clause may be appropriate for an institutional client, the Release stated that "there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions …"[9] The use of a hedge clause in an agreement with an institutional client will depend on the "particular facts and circumstances."[10] Advisers must address any conflicts of interest created by the hedge clause as required by their duty of loyalty. Further in this regard, the SEC withdrew the Heitman Capital Management No-Action Letter.[11]

III. Reasonable Inquiry

The SEC pointed out several differences between advising a retail client versus an institutional client, particularly as it relates to the adviser's obligation to make a reasonable inquiry into its client's circumstances.

A retail client's investment objectives may fluctuate due to various life events. As a result, when advising retail clients, an adviser must make an ongoing reasonable inquiry into the client's "investment profile," including its financial situation, level of financial sophistication, investment experience, and financial goals. The frequency with which an adviser must inquire and update a retail client's investment profile turns on individual facts, circumstances, and events.

However, an institutional client's investment objectives are typically fixed by the advisory agreement or its constituent documents. Therefore, when dealing with institutional clients, "the nature and extent of the reasonable inquiry into the client's objectives generally is shaped by the specific investment mandates from those clients."[12] Any obligation to update the investment objective of an institutional client should be set forth in the advisory agreement.

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8 Hedge clauses are often followed by "non-waiver disclosures" which explain that the client may have certain legal rights arising under federal and state securities laws which have not been waived. The key concern is that these antifraud provisions may be violated if such a clause is likely to lead a client to believe that it has waived non-waivable rights of action against the adviser that are provided by federal or state law.

9 Release at page 11, footnote 31.

10 *Id.*

11 Release at page 11, footnote 31; *See also* Heitman Capital Mgmt., LLC, SEC No-Action Letter, (Fed. 12, 2007). (On Feb. 12, 2007, the SEC issued a No-Action Letter which indicated that the use of a hedge clause, accompanied by non-waiver disclosure, would not *per se* violate Sections 206(1) and (2) of the Advisers Act. Instead, in the context of a retail client, the staff would consider numerous factors including, but not limited to, whether: (i) the hedge clause was written in plain English; (ii) the adviser highlighted and explained the hedge clause during an in-person meeting with the client; and (iii) the adviser provided enhanced disclosure to explain the instances in which such client may still have a right of action against the adviser).

12 Release at page 14.

IV. Conflicts

The SEC's proposed interpretation on fiduciary principles stated that an adviser must "seek to avoid" conflicts of interest with clients.[13] The Release clarifies that an adviser may satisfy the duty of loyalty by "making full and fair disclosure of conflicts of interest and obtaining the client's informed consent."[14] However, the requirement to obtain informed consent "does not require advisers to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed. Rather, disclosure should be designed to put a client in a position to be able to understand and provide informed consent to the conflict of interest."[15]

V. Full and Fair Disclosure

The SEC also pointed to potentially significant differences between the meaning of full and fair disclosure for institutional clients and retail clients. Institutional clients "generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[16] On the other hand, it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable enough for retail clients to provide their informed consent. In these cases, disclosure alone will not be sufficient, and the adviser should "either eliminate the conflict or adequately mitigate (*i.e.*, modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible."[17]

The Release stated that some conflicts "may be of a nature and extent that it would be difficult to provide disclosure to clients that adequately conveys the material facts or the nature, magnitude, and potential effect of the conflict sufficient for a client to consent to or reject it."[18] Despite taking the view that there are some conflicts that cannot be cured through disclosure, the SEC did not define what such conflicts might be. The Release, does however, provide some guidance as to (i) the appropriate level of specificity required, and (ii) the considerations for disclosure regarding conflicts related to the allocation of investment opportunities among eligible clients.[19] For example, disclosing that an adviser "may" have a particular conflict, without more, is not adequate when the conflict actually exists. Similarly, the use of "may" is insufficient if it simply precedes a list of all possible or potential conflicts regardless of likelihood. With respect to allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship. However, if a conflict exists, it would be

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[13] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-4889 (April 18, 2018) ("Proposed Release").

[14] Release at page 23, footnote 57.

[15] Release at page 27.

[16] Release at page 26.

[17] Release at page 28 (emphasis in original).

[18] Release at page 28.

[19] Release at page 24.

inadequate to disclose that the adviser has "other clients" without describing how the adviser will manage conflicts between clients.

The Release also makes clear that informed consent does not have to take the form of a written advisory contract. In fact, a client's informed consent can be either explicit or, "depending on the facts and circumstances, implicit."[20] It further explained that "a client generally may provide its informed consent implicitly 'by entering into or continuing the investment advisory relationship with the adviser' after disclosure of a conflict of interest."[21]

VI. Going Forward

- Advisers should assess their policies regarding the frequency with which they inquire and update a retail client's investment objectives. Additionally, advisers should determine whether they wish to specify the frequency of obligation to update in their advisory agreements.
- Advisers should evaluate their advisory agreements to ensure they are not using waiver language that would be prohibited by the Release.
- Advisers should determine whether they have made full and fair disclosure of conflicts and obtained the necessary informed consent from clients. In particular, advisers should assess the adequacy of any disclosure relating to the allocation of investment opportunities.
- Taking account of the sophistication of the clients that they serve, advisers should review and confirm that any disclosures are sufficiently specific and understandable enough for their clients to make an informed decision to consent to the conflict of interest.
- In relationships where a client has provided implied consent to a conflict, an adviser may want to identify evidence of such consent, or when possible, obtain explicit consent.

[20] Release at page 27.

[21] Release at page 27, footnote 68.

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