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Legal Update

SEC Publishes Final Interpretation of Investment Adviser Standard of Conduct

On June 5, 2019, the US Securities and Exchange Commission (SEC) published an interpretation of the standard of conduct for investment advisers under the Investment Advisers Act of 1940 (Advisers Act).[1] The objective of the Proposed and Final Interpretations was to reaffirm and clarify certain aspects of an adviser's fiduciary duty under Section 206 of the Advisers Act. In the SEC's view, the Final Interpretation does not create new obligations. This Legal Update describes the SEC's interpretation of an adviser's standard of care and, where important or interesting, compares points made in the Proposed Interpretation and those in the Final Interpretation.

Key points in the Final Interpretation are as follows.

1. The Final Interpretation took no action regarding imposing on registered advisers:

- Licensing and continuing education requirements for advisory representatives,
- Obligations to deliver advisory account statements to clients that include fees/costs of advisory services,[2] or
- Specific financial responsibilities (e.g., net capital requirements).

(The SEC noted that it continues to evaluate comments received.)

2. The Final Interpretation did not alter the overall interpretation that an investment adviser's fiduciary duty comprises two components: the duty of care and the duty of loyalty.

Fiduciary Duty Generally

In the SEC's view, an investment adviser's obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty. As discussed in more detail below, 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. Under its duty of loyalty, an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser (consciously or unconsciously) to render advice which is not disinterested so that a client can provide informed consent to the conflict.[3]

The investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship, including advice about investment strategy, sub-adviser engagement, account type (whether to open and which type) and account roll overs. This duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement provided that there is full and fair disclosure and informed consent. Accordingly, an adviser's fiduciary duty must be evaluated in the context of the agreed-on scope of the relationship between the adviser and the client. In particular, the specific obligations that flow from the adviser's fiduciary duty depend on what functions the adviser has agreed to assume for the client.[4]

Duty of Care

The Final Interpretation states that an adviser's duty of care includes the following three areas, among others (although the SEC did not state what those others are):

- The duty to provide **advice that is in the best interest** of the client.

This duty is described as the duty to provide investment advice that is in the best interest of the client, including a duty to provide advice that is suitable for the client based on an understanding of the client's investment objectives. This duty applies not only to investment recommendations but also to recommendations of type of account as well (e.g., advisory, brokerage, wrap, rollover accounts)[5] and has two underlying requirements: the adviser must make a "reasonable inquiry" into the client's investment objectives such that it has a reasonable understanding of the same and must have a "reasonable belief" that the advice is in the best interest of the client, based on the client's objectives.[6]

In ascertaining what the objectives are for retail clients, the SEC guides advisers to develop a reasonable understanding of investment objectives by use of investment profiles. Profiles should capture the retail client's financial situation, level of financial sophistication, investment experience and financial goals. Information provided in the investment profile of retail clients should be updated to the extent reasonable. An adviser to a retail client providing ongoing investment advice also must update the profile.

For institutional clients, a reasonable understanding of investment objectives should be covered in the investment mandate for an advisory account (whether a separately managed account or a registered or private fund). The SEC did not define "retail client" or "institutional client" in the Final Interpretation.

The SEC stated that establishing a reasonable belief that the advice is in the client's best interest would involve a risk/benefit analysis, with heightened scrutiny in certain circumstances. In addition, the SEC stated that cost (including fees and compensation) associated with the proposed investment is one of the many important factors to consider but not necessarily a determinant—the SEC stated that fiduciary duty "does not necessarily require an adviser to recommend the lowest cost investment product or strategy."[7] Other factors include the investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit.[8]

The SEC stated that, in addition to conducting an overall assessment of the proposed investment based on the adviser's understanding of the client's investment profile, this duty also requires an adviser to conduct a "reasonable investigation" of the proposed investment to sufficiently avoid basing its advice on materially inaccurate or incomplete information. The SEC did not indicate what level of investigation is required but did mention the concept of an independent investigation.[9]

- The duty to **seek best execution** when the adviser is responsible for selecting the channel through which transactions in securities will be executed.

The SEC reiterated the traditional two-pronged analysis for selecting where to place client transactions for execution of favorable cost and best qualitative service.[10]

- The duty to **provide advice and monitor accounts over the course of the relationship** at an appropriate frequency.

The duty to monitor the account is based on the relationship and its expected duration. Therefore, an adviser's monitoring role would be different for a client receiving a one-time financial plan versus a discretionary account over which the adviser has investment discretion. That monitoring role includes periodic evaluation of whether the account type continues to be best for the client. The adviser and client may determine the frequency of monitoring, with full and fair disclosure and informed consent. The SEC mentioned that advisers might consider whether written policies and procedures related to monitoring would be appropriate.[11]

Duty of Loyalty

The duty of loyalty requires that an adviser not subordinate its client's interests to its own (i.e., must not place its own interest ahead of its client's interests). In describing its view on the duty of loyalty, the SEC appears to have loosened important concepts from the Proposed Interpretation in the Final Interpretation. For example:

- The Proposed Interpretation stated that "[d]isclosure of a conflict, alone, is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act." The SEC stated in the Final Interpretation that "[w]e disagree that this Final Interpretation includes a requirement to eliminate conflicts of interest….elimination of a conflict is one method of addressing that conflict; when appropriate advisers may also address the conflict by providing full and fair disclosure such that a client can provide informed consent to the conflict."[12] However, this more flexible posture was muted by additional SEC commentary regarding the extent to which disclosure can be used as a "cure-all" for breaches, as discussed below.
- The Proposed Interpretation stated that in allocating investment opportunities, an adviser has a duty to treat all clients fairly, with an inference being that if disclosed to a second client that a first client had priority over certain investments, and the second agreed, that could still be a breach of this duty. The SEC stated in the Final Interpretation that this situation would not be a breach.[13]
- The Proposed Interpretation stated that inferring or accepting client consent to a conflict would not be consistent with the fiduciary duty where "the material facts concerning the conflict could not be fully and fairly disclosed." The Final Interpretation replaced that statement with specific examples of how advisers can make such full and fair disclosure.[14]

Although the statements in the Final Interpretation affirming the legitimacy of relying on full and fair disclosure to address a conflict of interest are a relief, they are muted by the SEC's posture that while disclosure of a conflict of interest might satisfy the duty of loyalty, it would *not* cleanse overreaching or taking unfair advantage of a client's trust, i.e., cleanse a breach of the duty of care to act in a client's best interest.[15] This raises a specter that under some circumstances disclosure, even fully and fairly made, will not be a cure-all for a breach of fiduciary duty.

In terms of full and fair disclosure and informed consent, the adviser must provide disclosures that are sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent. The adviser need not ascertain, or have to prove, client understanding, but the SEC warned that it would not be consistent with an adviser's fiduciary duty to infer or accept client consent where the adviser was aware or reasonably should have been aware that the client didn't understand the nature and import of the conflict.[16] Accordingly, consideration should be given to the type of client, e.g., retail vs. institutional.

The disclosure/informed consent need not be in a contract. Inclusion in an adviser's Form ADV and other forms of disclosure would suffice. However, the SEC made clear that it would not be sufficient just to disclose a conflict of interest without also explaining how the conflict could affect the advice given. In writing disclosure of a conflict of interest, therefore, it is important to ask, "so what?"

Lastly, the SEC made clear that disclosure is not the only way to address a conflict of interest or meet the duty of loyalty. Elimination of a conflict of interest, as well as mitigation of a conflict (with appropriate disclosures), is an alternative method to deal with a conflict.

Notably, the SEC did not provide guidance in the release regarding how advisers should obtain consent from their private fund clients or how understandability of disclosure should be applied in that context.

Hedge Clauses and the Withdrawal of the Heitman Capital Management No-Action Letter

At least since 2007, if not before, advisers have sought contractual ways to limit liability, primarily by including indemnification and exculpation provisions—a so-called hedge clause. In 2007, the SEC staff issued a no-action letter to Heitman Capital Management, LLC (pub. avail. Feb. 12, 2007), confirming that whether such a hedge clause would violate an adviser's fiduciary duty would depend on all the facts and consideration of the form and content in which the hedge clause was made. In the context of a retail client, the staff no-action letter described three factors to consider:

- Whether the hedge clause was written in plain English;
- Whether the hedge clause was highlighted and explained in person; and
- Whether the hedge clause disclosure explained when a client might still have a right of action notwithstanding language in the clause conveying the contrary.

To this extent, and to the extent that hedge clauses were included in contracts with institutions and sophisticated intermediaries (e.g., wrap fee program sponsors), the staff concluded that, while dependent on the facts, such clauses would not constitute a *per se* violation of Sections 206(1) and (2) of the Advisers Act.

In the Final Interpretation, the SEC withdrew the Heitman no-action letter, noting that some commenters suggested some have misapplied the staff's position in that letter. In doing so, the SEC took the occasion to state that "an adviser's federal fiduciary duty may not be waived, though its application may be shaped by agreement."[17]

It reaffirmed the general position that a determination that a hedge clause raises a potential violation of the Advisers Act fiduciary duty is a fact-intensive evaluation (including evaluation of the client's particular circumstances and sophistication). The SEC made clear that a contract provision purporting to waive the adviser's federal fiduciary duty generally—such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest or (iii) a waiver of any specific obligation under the Advisers Act—would be inconsistent with the Advisers Act, regardless of the sophistication of the client. Leaving the factual nature of this analysis in the context of an institutional client alone, the SEC made abundantly clear:

> In our view, however, 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, where the hedge clause purports to relieve the adviser from liability for conduct as to which the client has a non-waivable cause of action against the adviser provided by state or federal laws. Such a hedge clause generally is likely to mislead those retail clients into not exercising their legal rights, in violation of the antifraud provisions, even where the agreement otherwise specifies that the client may continue to retain its non-waivable rights.[18]

The SEC did not define the terms "retail client" or "institutional client" and did not indicate how advisers to pooled investment vehicles should apply the above principles.

There are some takeaways from this action. First, although the Heitman no-action letter was withdrawn, the SEC did not take action that would force a reversal of customary practice of limiting liability in contracts with institutional clients. Generally those practices should not be viewed as a *per se* violation of the antifraud provisions. Second, the contrary position would appear to be the case regarding use of hedge clauses in retail client agreements. To the extent that advisers currently include those provisions in contracts with retail clients, even with non-waivable disclosure (the standard language that, notwithstanding the hedge clause, a client is not waiving any rights it might have under state or federal law), they should be abandoned. Related to that, the SEC appears to have suggested that the inclusion of non-waivable disclosure is not effective and, accordingly, should no longer be relied on with respect to retail clients.

Finally, the SEC raised a need to consider whether inclusion of a hedge clause in an investment management agreement might present a conflict of interest obligating the adviser to provide full and fair disclosure of that conflict (e.g., limitation of the adviser's liability could prompt the adviser to be less vigilant in managing the institutional account than would otherwise be the case if the contract did not contemplate limitation on liability). It will be interesting to see if this comment gains any traction by drafters of hedge clauses.

Conclusion

On balance, it appears that no new fiduciary obligations were created in the Final Interpretation, although it does appear to implicate additional steps that advisers should be taking in certain circumstances. Time will tell if current practices, particularly with respect to conflicts disclosures and hedge clauses, morph as a result of this Final Interpretation.

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Endnotes

[1] Investment Advisers Act Release No. 5248 (June 5, 2019) (Final Interpretation), *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf. The Final Interpretation was first proposed in Investment Advisers Act Release No. 4889 (Apr. 18, 2019) (Proposed Interpretation), *available at* https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

[2] Imposing this obligation on investment advisers would require an amendment to the books and records rule contained in Rule 204-2 under the Advisers Act as the obligation to prepare and send account statements is currently not required.

[3] Final Interpretation at 6-8.

[4] *Id.* at 8-11. For these reasons, it is important to clearly define the scope of the adviser-client relationship, initially and over the course of the relationship, particularly if the adviser has other, non-advisory lines of business.

[5] The SEC made clear its view that advisers have an affirmative duty to make only suitable recommendations and that a rule establishing this express obligation is not necessary. The SEC also applies this duty to prospective clients. The SEC believes that, in order to avoid liability under Section 206, an adviser should have sufficient information about the prospective client and its objectives to form a reasonable basis for advice before providing any advice about these matters. At the point in time at which the prospective client becomes a client of the investment adviser (e.g., at account opening), the fiduciary duty applies. Accordingly, while advice to prospective clients about these matters must comply with the antifraud provisions under Section 206, the adviser must also satisfy its fiduciary duty with respect to any such advice (e.g., regarding account type) when a prospective client becomes a client. The SEC stated that in providing advice to a client or customer about account type, a financial professional who is dually licensed should consider all types of accounts offered (i.e., both brokerage accounts and advisory accounts) when determining whether the advice is in the client's best interest. Subject to a best interest determination, a financial professional who is only a supervised person of an investment adviser can recommend only advisory accounts that the adviser offers or can advise a client to consider a non-advisory account (or to speak with other personnel at a dual registrant or affiliate about a non-advisory account). This same framework would apply to a prospective client, but any advice or recommendation given to a prospective client would be subject to the antifraud provisions of the federal securities laws.

[6] Final Interpretation at 12-18.

[7] A recommendation of a higher cost product or strategy is not necessarily a breach of duty if the adviser "reasonably concludes that there are other factors about the investment or strategy that outweigh cost and make the investment or strategy in the best interest of the client, in light of that client's objectives." The SEC did not indicate whether or how an adviser is expected to demonstrate this. Final Interpretation at 17-18.

[8] *Id.* at 17,

[9] *Id.* at 16.

[10] The SEC resisted a commenter's request to prescribe specific requirement of how an adviser might satisfy its best execution obligation. Final Interpretation at 19-20,

[11] *Id.* at 20-21,

[12] *Id.* at 38-40. The Final Interpretation covered several examples of disclosure approaches to conflicts of interest that would and would not suffice. So, for example, the SEC described the case involving Robare where a conflicted situation is known to exist but described as "may" raise a conflict of interest (citing In the Matter of The Robare Group, Ltd., et al., Investment Advisers Act Release No. 4566 (Nov. 7, 2016)). Clearly the SEC continues to dig its heels in on this point and stated that use of "may" in this circumstance would be "inappropriate." If, on the other hand, a conflicted situation does not currently exist but could present itself, the SEC stated that use of "may" would be acceptable.

[13] Final Interpretation, footnote 66 and accompanying text.

[14] *Id*. at 27-29.

[15] *Id.* at 28.

[16] *Id*. at 27-29.

[17] *Id.* at footnote 31.

[18] *Id.*

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