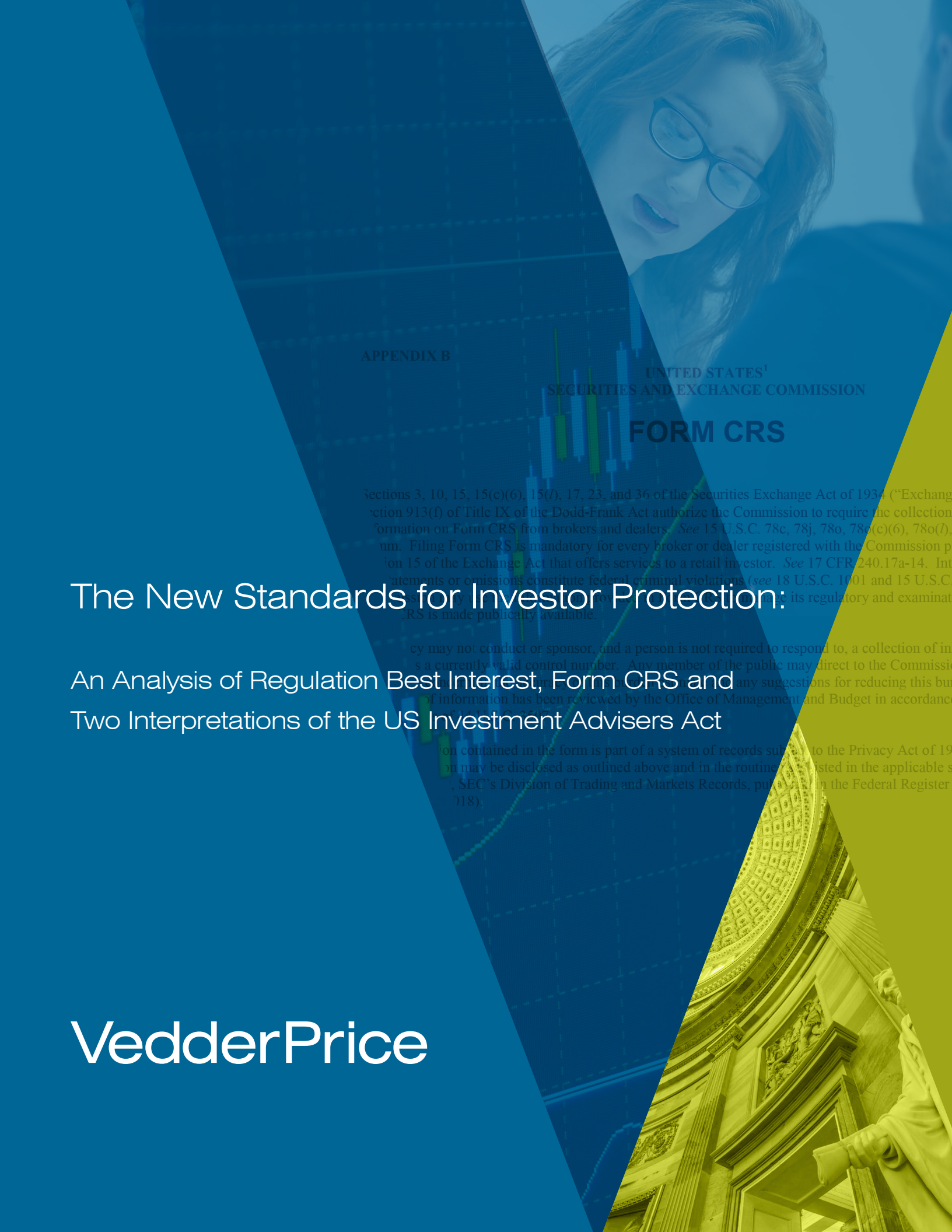

The New Standards for Investor Protection:

An Analysis of Regulation Best Interest, Form CRS and Two Interpretations of the US Investment Advisers Act

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THE NEW STANDARDS FOR INVESTOR PROTECTION: AN ANALYSIS OF REGULATION BEST INTEREST, FORM CRS AND TWO INTERPRETATIONS OF THE US INVESTMENT ADVISERS ACT

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TABLE OF CONTENTS

INTRODUCTION

On June 5, 2019, the Securities and Exchange Commission (the "SEC") voted three to one to approve a package of rulemakings and interpretations designed to enhance the quality and transparency of investors' relationships with investment advisers and broker-dealers (the "June 5 Release"). Adopted pursuant to the broad rulemaking authority granted in Section 913(f) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the June 5 Release consists of the following four components:

1. Regulation Best Interest: The Broker-Dealer Standard of Conduct ("Reg BI") (Applies to Broker-Dealers; Compliance Date June 30, 2020);

2. Form CRS Relationship Summary; Amendments to Form ADV ("Form CRS") (Applies to Broker-Dealers and Registered Investment Advisers; Compliance Date June 30, 2020);

3. Commission Interpretation Regarding Standard of Conduct for Investment Advisers ("Fiduciary Interpretation") (Applies to *all* Investment Advisers; Effective July 12, 2019); and

4. Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser ("Solely Incidental Interpretation") (Applies to Broker-Dealers; Effective July 12, 2019).

The reason for the June 5 Release is to enhance investor protection, especially at the retail level. To paraphrase the SEC's own words, the Adopting Release for Reg BI (the "Reg BI Release") provided the following reasons behind its approval: (i) to help retail customers better understand and compare the services offered by investment advisers and broker-dealers and enable them to make informed choices to establish a relationship best suited to their needs, (ii) to provide clarity with respect to the standards of conduct applicable to investment advisers and broker-dealers and (iii) to foster greater consistency in the level of protection provided to each regime, particularly at the point at which a recommendation is made.[1]

This article provides guidance on how investment advisers and broker-dealers can navigate and comply with each of the four components of the June 5 Release. Given the large scope of these rules and interpretations, this guidance will be presented in an outline format, and each of the four components will begin with the type of SEC registrant it applies to as well as the component's effective date.

Regulation Best Interest

(Applies to broker-dealers; compliance date June 30, 2020)

I.
REGULATION BEST INTEREST
(Applies to broker-dealers; compliance date June 30, 2020)

A. The General Obligation and Overview

Reg BI is codified under Rule 15l-1 of the Securities Exchange Act of 1934 (the "Exchange Act") and is designed to improve *retail* investor protection. Reg BI does not create a "fiduciary" standard for broker-dealers.[2] Reg BI instead establishes a new standard of conduct for broker-dealers and their "associated persons" (unless otherwise indicated, together referred to as a "broker-dealer") when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities.[3]

Reg BI enhances the broker-dealer standard of conduct beyond the previous suitability obligation. Due to the changes enacted by Reg BI, the Financial Industry Regulatory Authority ("FINRA") will likely be reviewing the application of the rule and updating its rulebook. When making a recommendation, a broker-dealer must now act in the retail customer's *best interest* and cannot place its own interests ahead of the customer's (the "General Obligation"). The General Obligation is satisfied only if the broker-dealer complies with four specific sub-component obligations, each of which is further defined below: the (i) Disclosure Obligation, (ii) Care Obligation, (iii) Conflict of Interest Obligation and (iv) Compliance Obligation. A violation of any of the four components will cause a violation of the General Obligation.[4] Scienter or intent is not required in order to establish a violation of the General Obligation.

Of note, Reg BI does not extend beyond a particular recommendation, require a continuous duty to a retail customer or impose any duty to monitor. It also does not require a broker-dealer to refuse a customer's order contrary to the broker-dealer's recommendation or apply to a retail customer's self-directed or unsolicited transaction request.[5] A broker-dealer cannot avoid compliance with Reg BI, nor can a retail customer agree to waive his or her protections. Reg BI does not create any private right of action or right of rescission.[6]

B. Key Terms

As noted above, the General Obligation applies when a broker-dealer makes a *recommendation to a retail customer of any securities transaction or investment strategy involving securities*. Each part of this three-part test must be satisfied for the General Obligation to apply, and therefore it is critical to have an understanding of the following terms:

1. Recommendation: Reg BI did not provide a definition of the term "recommendation," but did offer guidance, such as whether a communication "reasonably could be viewed as a call to action" or "reasonably would influence an investor to trade a particular security or group of securities."[7] Communications such as providing investment education, descriptive information about an investment, certain asset allocation models and interactive investment materials would not be considered a recommendation.[8]

2. Retail Customer: Reg BI defines "retail customer" as a "natural person, or the legal representative of a natural person, who receives a recommendation of any securities transaction or investment strategy involving

a security, and uses that recommendation primarily for personal, family or household purposes." The Reg BI Release interpreted "personal, family or household purposes"[9] to mean any account recommendation except when used for *commercial or business purposes*.[10] Importantly, this definition is broader in scope than the definition of "retail investor" in FINRA rules as it includes natural persons with assets above $50 million.

In addition, the Reg BI Release noted that the term "legal representative" would include "nonprofessional legal representatives" of a natural person such as a nonprofessional trustee.[11] The term would also include certain legal entities (such as a trust) that represent the assets of a natural person.[12] Regulated financial professionals retained by a natural person would not be considered a legal representative (e.g., registered investment advisers, broker-dealers, banks, trust companies and insurance companies) and "break the chain" of Reg BI's applicability.[13]

3. Securities Transactions or Investment Strategy: Reg BI provided the following examples of a "securities transaction" or "investment strategy:" (i) recommending the purchase, sale or exchange of a security, (ii) an explicit "hold" recommendation, (iii) recommending an agreement to perform account monitoring, (iv) recommending the taking of a distribution from the proceeds of a specific security, or (v) recommending the taking of in-service loans from an employer-sponsored plan. Reg BI would further apply to making an "account recommendation" in the form of (i) a general recommendation regarding a securities account (e.g., opening an IRA, brokerage or advisory account) or (ii) a recommendation to roll or transfer assets from one type of account to another (e.g., from a workplace retirement plan to an IRA). If these terms are satisfied, a broker-dealer must then ensure compliance with the four sub-component obligations of the General Obligation. These four sub-components are examined below in greater detail.

C. The Disclosure Obligation

Reg BI provides that, *before or at the time of a recommendation*, a broker-dealer must disclose in writing all material facts about the scope and terms of its relationship with a customer (the "Disclosure Obligation").[14] Pursuant to this obligation, the Reg BI Release noted the following facts are deemed to be material and must be disclosed:

1. Capacity in Which the Broker-Dealer Is Acting: A broker-dealer must disclose that it is acting as a broker, a dealer or an associated person of a broker-dealer with respect to the recommendation. Use of the term "adviser" or "advisor" by a broker-dealer or an associated person not registered in that capacity will violate the Disclosure Obligation.[15]

2. Fees and Costs: A broker-dealer must disclose the material fees and costs that apply to the retail customer's transactions, holdings and accounts. This disclosure could include an explanation of how and when fees are deducted from the customer's account (e.g., on a per-transaction basis or quarterly). A broker-dealer can also refer a retail customer to any prospectus, PPM or offering circular in which more information can be found.[16] In general, a broker-dealer must go beyond the fee disclosure provided on Form CRS to satisfy this obligation.

The Disclosure Obligation does not require individualized fee disclosures for each retail customer. Instead, fees and costs can be provided in standardized numerical and narrative disclosures (e.g., standardized or hypothetical amounts, dollar

or percentage ranges, and explanatory text). The disclosure must accurately convey why a fee is being imposed and when the fee will be charged. [17]

3. Type and Scope of Services: A broker-dealer must disclose the type and scope of services provided to the retail customer, *including any material limitations* on the securities or investment strategies that may be recommended to the retail customer. The Reg BI Release includes the following examples of facts that are deemed to be material and which would require disclosure:

   - whether the broker-dealer has material limitations on the securities or investment strategies that may be recommended to a retail customer;[18]
   - whether the broker-dealer provides account monitoring, and the scope and frequency of any such monitoring;
   - whether a broker-dealer has any account balance requirements;
   - the "general basis" for a recommendation (i.e., what might commonly be described as the firm or associated person's investment approach, philosophy or strategy); and[19]
   - the "general risks" associated with a broker-dealers or associated person's recommendations in standardized (not individualized) terms.

4. Material Facts Related to Conflicts of Interest: A broker-dealer must disclose "material facts relating to conflicts of interest" associated with a recommendation.[20] In particular, the Reg BI Release mentioned the following conflicts of interest which would be deemed "material facts" and require disclosure:

   - Disclosure of Compensation: This disclosure should summarize how the broker-dealer and its financial professionals are compensated for their recommendations.[21]
   - Differences in Compensation and Proprietary Products: This disclosure would apply to "variable compensation schemes" pursuant to which a broker-dealer could receive higher compensation for recommending some products rather than others. This disclosure would also apply to the recommendation of proprietary products.[22]

5. Form and Manner of Disclosure: Broker-dealers have flexibility in satisfying the Disclosure Obligation, and therefore there is no standard written document that must be used. A broker-dealer may use existing disclosures or documents such as product prospectuses, relationship guides, an account agreement or a fee schedule. However, disclosures may need to be tailored to specific recommendations if the existing document does not identify specific conflicts of interest. A broker-dealer may use Form CRS as part of its Disclosure Obligation, but it would likely have to provide additional information to satisfy its overall obligation.[23]

   Furthermore, to satisfy the Disclosure Obligation, disclosure must be in writing, and, in limited circumstances, supplemental disclosure could be done verbally; however, a broker-dealer would have to maintain a record of such disclosure. The Reg BI Release encourages broker-dealers to use plain English in preparing any disclosures, and electronic delivery is permitted (however, paper copies must also be made available upon request). With regard to updating their disclosures, the Reg BI Release provided broker-dealers should process such updates no later than thirty (30) days after a material change.[24]

D. The Care Obligation

Reg BI enhances the previous suitability obligation and requires a broker-dealer to "exercise reasonable

diligence, care and skill" in meeting three components that make up the care obligation (the "Care Obligation"), each of which is summarized below.[25] By way of background, the first component must be satisfied in order for the broker-dealer to move to and consider the second component. The third component arises only when a broker-dealer is recommending a series of transactions.

1. Reasonable-Basis Component: A broker-dealer must understand the potential risks, rewards and costs associated with a recommendation and have a reasonable basis to believe the recommendation could be in the best interest of at least *some* retail customers.

   To satisfy this component, broker-dealers should consider important factors such as the security's or investment strategy's (i) investment objectives, (ii) characteristics (including any special or unusual features), (iii) liquidity, (iv) volatility, (v) likely performance in a variety of market and economic conditions, (vi) expected return and (vii) financial incentives.[26] Consideration of these factors is especially important when recommending a security or an investment strategy that is complex or risky, such as inverse or leveraged exchange-traded products, penny stocks or illiquid securities.[27]

   Once a broker-dealer develops an understanding of a security or investment strategy and believes it could be in the best interest of at least some retail customers, the broker-dealer would then need to "apply that understanding to reasonably determine that the recommended product or strategy is in the *particular* retail customer's best interest at the time of the recommendation."[28]

2. Customer-Specific Component: A broker-dealer must have a reasonable basis to believe the recommendation is in the best interest of a *particular* retail customer and does not place the broker-dealer's interest ahead of the retail customer.

   To satisfy this component, a broker-dealer must weigh the potential risks, rewards and costs of a particular security or investment strategy against a *retail customer's investment profile* when making a particular recommendation.[29] For example, a broker-dealer would not satisfy the Care Obligation by simply recommending the least expensive or least lucrative security without a further analysis of a retail customer's investment profile. Conversely, a broker-dealer could recommend a more lucrative security or investment strategy if there is a reasonable basis to believe it would be in the best interest of the customer based on the customer's investment profile.

   An important part of the customer-specific component is the requirement that a broker-dealer consider "reasonably available alternatives" prior to making a recommendation. To satisfy this standard, a broker-dealer should have a process for establishing and understanding the scope of such "reasonably available alternatives" that would be considered by an associated person or group (e.g., groups that specialize in particular product lines). A broker-dealer would not be required to evaluate every possible alternative offered outside the firm or on the firm's platform.[30] In addition, a broker-dealer could not use its limited menu (e.g., offering only proprietary products or another limited range of products) to justify recommending a product not in a retail customer's best interest.[31]

   Reg BI does not require a broker-dealer to document its process in satisfying the Customer-Specific Component, although the Reg BI Release recommended supporting documentation where a recommendation could appear unreasonable on its face.[32]

3. Quantitative-Care Component: A broker-dealer must have a reasonable basis to believe that when recommending a series of transactions, the transactions taken together are not excessive, even if each is in the customer's best interest when viewed in isolation.

A broker-dealer is required to always form a reasonable basis as to the recommended frequency of trading in a retail customer's account, regardless of whether the broker-dealer has any level of "control" over the account. A broker-dealer will need to reasonably believe that a series of transactions is in the best interest of the customer and does not place the broker-dealer's interest ahead of the customer's. The Reg BI Release declined to provide a working definition for a "series of transactions," instead pointing to existing guidelines under the federal securities laws and SRO rules regarding terms such as turnover rate, cost-to-equity ratio and use of in-and-out trading.[33]

E. The Conflict of Interest Obligation

Reg BI requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to (i) identify and at a minimum disclose, or eliminate, all conflicts of interest associated with a recommendation and (ii) adopt specific requirements with respect to policies and procedures for the mitigation and elimination of certain conflicts of interest (the "Conflict of Interest Obligation"). In general, all conflicts of interest associated with a recommendation must be disclosed, and some conflicts must be mitigated or eliminated.

With respect to the first part, a broker-dealer must have reasonably designed policies and procedures that establish a process to *identify* and determine how to address a conflict.[34] All such identified conflicts must then be at a minimum disclosed (pursuant to the Disclosure Obligation) or eliminated in lieu of disclosure.

The second part of the Conflict of Interest Obligation deals with certain conflicts for which disclosure alone is insufficient. Accordingly, a broker-dealer must have policies and procedures designed to mitigate or eliminate these conflicts of interest. This requirement can be broken down into the following three sub-parts:

1. Policies and procedures reasonably designed to identify and mitigate conflicts of interest associated with certain recommendations *that incentivize* a broker-dealer to place its interest ahead of the interest of the retail customer.[35]

   - The Reg BI Release noted that broker-dealers have "flexibility" to develop reasonably designed policies and procedures that include conflict mitigation measures based on the circumstances of the firm. Specific mitigation methods were also discussed in the Reg BI Release.[36]

2. Policies and procedures reasonably designed to identify and mitigate conflicts of interest associated with *material limitations* on the securities or investment strategies involving securities that may be recommended to the retail customer.

   - The Reg BI Release noted that certain broker-dealers have material limitations on the recommendations they make to a retail customer, such as offering only proprietary products, products of a specific asset class or products with third-party arrangements such as revenue sharing.
   - When a broker-dealer places such material limitations on its recommendations, the firm's policies and procedures must be reasonably designed to (i) disclose the limitations and associated conflicts and (ii) prevent the limitations from causing the associated person or broker-dealer from placing the associated person's or broker-dealer's interests ahead of the customer's interest.

3. Policies and procedures reasonably designed to identify and *eliminate* certain conflicts of interest.

   - Reg BI requires broker-dealers to eliminate the following conflicts of interest when *based on a limited period of time*:[37] (i) sales contests, (ii) sales quotas, (iii) bonuses and (iv) noncash compensation, that are based on the sale of specific securities or specific types of securities.[38]

F. The Compliance Obligation

Reg BI requires a broker-dealer to establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Reg BI as a whole (the "Compliance Obligation"). The broker-dealer's policies and procedures must address not only conflicts of interest but also compliance with its Disclosure Obligation and Care Obligation.[39]

In addition to the policies and procedures required as part of the Compliance Obligation, the Reg BI Release noted that depending on the size and complexity of a firm, a reasonably designed compliance program generally would also include the following: (i) remediation of noncompliance, (ii) compliance training and (iii) periodic review and testing.

G. Dual Registrants

The Reg BI Release specifically stated that Reg BI will *not* apply to investment advice provided to a retail customer by a dual registrant in its capacity as an investment adviser.[40] The Reg BI Release further noted a "facts and circumstances" test will determine the capacity in which a dual registrant makes a recommendation, but specific factors the SEC staff will consider include the following: (i) the type of account, (ii) how the account is described, (iii) the type of compensation and (iv) the extent to which the dual registrant made clear to the customer or client the capacity in which it was acting.[41]

H. Books and Records Requirements

The overarching books and records obligation is that a broker-dealer must maintain a record of all information collected from and provided to retail customers pursuant to Reg BI. Examples of new recordkeeping requirements under the rule include the "retail customer investment profile" pursuant to the Care Obligation and all written disclosures provided to a retail customer pursuant to the Disclosure Obligation. Importantly, broker-dealers are not required to maintain records to evidence determinations of best interest on a recommendation-by-recommendation basis. Rather, a broker-dealer should be able to explain in broad terms the process by which it determines a recommendation is in a customer's best interest and how that process is applied to a particular recommendation.[42]

With respect to these recordkeeping requirements, broker-dealers would be required to retain all records of the information collected from or provided to each retail customer pursuant to Reg BI for at least six (6) years after the *earlier* of the date on which the account was closed or the date on which the information was replaced or updated.[43] In addition, the neglect, refusal or inability of a retail customer to provide or update such information will excuse a broker-dealer from obtaining that information.[44]

Form CRS

(Applies to Broker-Dealers and Registered Investment Advisers; Compliance Date June 30, 2020)

II.
FORM CRS
(Applies to broker-dealers; compliance date June 30, 2020)

A. Overview and Background

Form CRS is a disclosure document meant to reduce *retail* investor confusion about fees, conflicts of interest and the required standard of conduct for a particular firm. Importantly, if a registered broker-dealer or registered investment adviser (together, "firms") does not interact with retail investors, that firm does not have to prepare Form CRS.[45] The final instructions for Form CRS are very specific and include mandatory disclosures. Firms are encouraged to carefully review these instructions when preparing and updating Form CRS. (See https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf).

Overall, Form CRS will provide a summary of information about relationships and services offered to retail investors, fees and costs, conflicts of interest, the required standard of conduct and whether firms or their financial professionals have any reportable legal or disciplinary history. Form CRS needs to be written in "plain English" and may not be longer than two (2) pages for a stand-alone firm (or four (4) pages for a dual registrant).[46] It will have a question-and-answer format under standardized headings, will include certain "conversation starters" and must respond to items in a prescribed order. Form CRS must also highlight the SEC's investor education website, Investor.gov, which offers educational information to investors on investment advisers, broker-dealers and individual financial professionals.

B. Initial Filing Requirements

A broker-dealer that has retail investors must complete Form CRS and file it electronically with Web CRD by June 30, 2020.

A registered investment adviser that has retail investors must complete Form ADV, Part 3 (Form CRS) and file it electronically with the IARD by June 30, 2020.

C. Delivery Requirements

A broker-dealer must deliver Form CRS to a new or prospective client before or *at the earliest* of (i) a recommendation of an account type, a securities transaction or an investment strategy involving securities, (ii) placing an order for the retail investor or (iii) opening a brokerage account for the retail investor.[47]

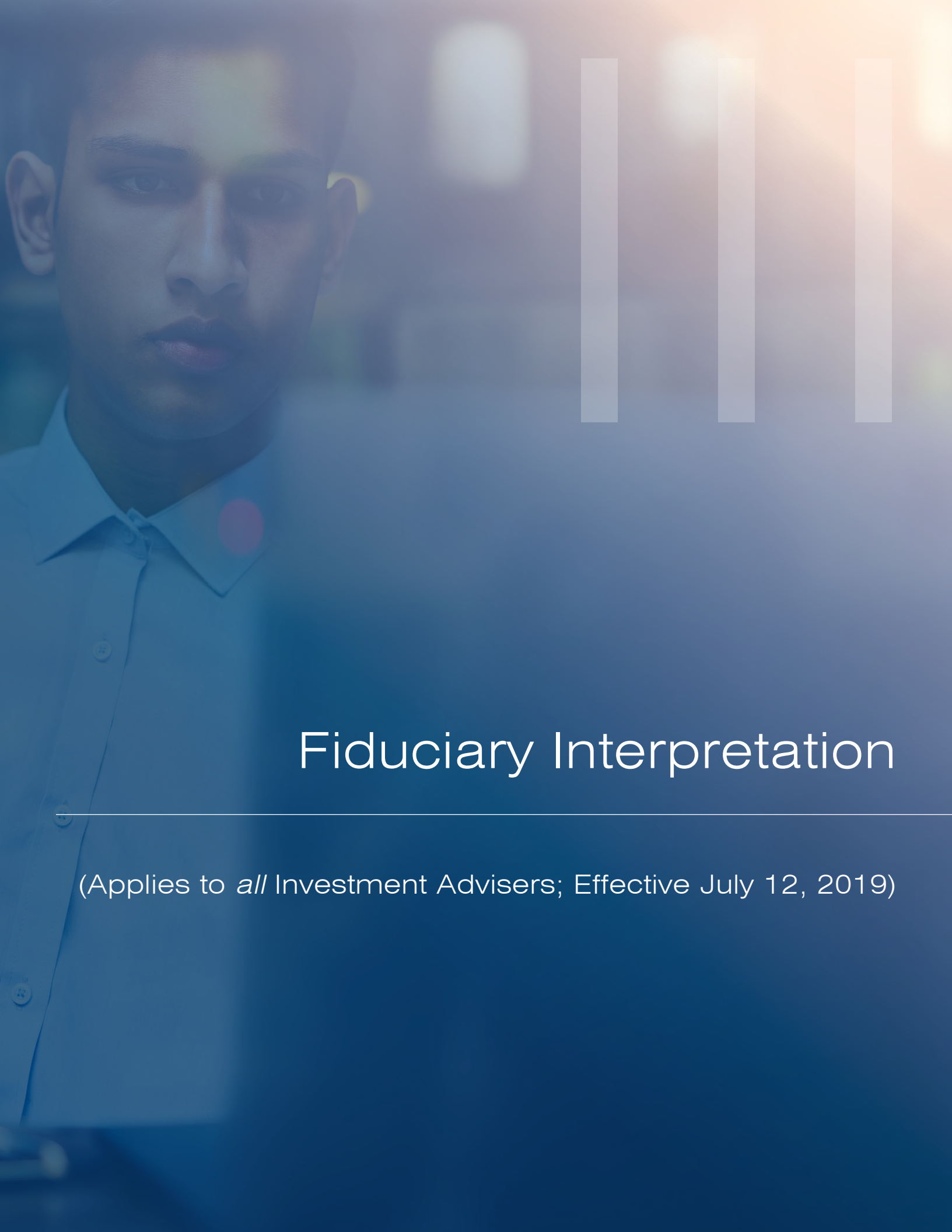
An investment adviser must deliver Form CRS to a new or prospective client before or at the time of entering into an advisory contract.

A broker-dealer or investment adviser must deliver Form CRS to an *existing* customer before or at the time the firm (i) opens a new account that is different from the customer's existing account, (ii) recommends that the customer roll over assets from a retirement account or (iii) recommends or provides a new service or investment outside of the existing account.[48]

D. Updating and Recordkeeping Requirements

Firms must update Form CRS when information becomes materially inaccurate. The updated Form CRS must be posted on a firm's website and electronically filed in Web CRD or the IARD within thirty (30) days of the material change. An updated version of Form CRS must also be delivered to existing retail investors within sixty (60) days of the update (electronic delivery is acceptable). The updated version must be accompanied with a marked copy of the revised text (i.e., a blackline) or by including a summary of the material changes.

Pursuant to the amendments of Rule 204-2 of the Investment Advisers Act of 1940 (the "Advisers Act") and Rules 17a-3 and 17a-4 of the Exchange Act, investment advisers and broker-dealers must maintain a record of the date that each Form CRS was given to each retail investor.[49] Broker-dealers must maintain a version of each Form CRS for at least six (6) years after each version is created, the first two (2) years in an easily accessible place.[50] Investment advisers have a similar requirement to maintain each Form CRS in an easily accessible place for a period of not less than five (5) years from the end of the fiscal year during which the last entry was made on such record, the first two (2) years in an appropriate office of the investment adviser.[51]



Fiduciary Interpretation

(Applies to *all* Investment Advisers; Effective July 12, 2019)

III.
FIDUCIARY INTERPRETATION
(Applies to *all* Investment Advisers; effective July 12, 2019)

A. Overview and Background

The June 5 Release included an interpretation regarding the standard of conduct for investment advisers (previously defined as the "Fiduciary Interpretation").[52] In the SEC's words, "[t]he [Fiduciary] Interpretation is intended to reaffirm, and in some cases clarify, certain aspects of an investment adviser's fiduciary duty under the Advisers Act . . . . [and] does not itself create any new legal obligations for advisers."[53] Though not explicitly defined in the Advisers Act or in any SEC rules thereunder, based on equitable common law principles and congressional intent, courts have interpreted the antifraud provisions of the Advisers Act (specifically, Sections 206(1) and (2)[54]) to establish a fiduciary duty for investment advisers.[55] The SEC states in the Fiduciary Interpretation Release that the Advisers Act establishes a fiduciary duty for investment advisers that applies to all aspects of the adviser-client relationship.[56] As explored in more detail below, this fiduciary duty comprises: (i) a duty of care and (ii) a duty of loyalty, which the SEC believes is best addressed based upon fiduciary principles, as opposed to adopting a (perhaps more rigid) rule, to permit advisers to meet their fiduciary obligations in the context of the specific facts and circumstances surrounding their client relationships.[57]

B. Application of Duty Determined by Scope of Relationship

Consistent with the SEC's principles-based approach and in recognition of the fact that investment advisers provide a wide range of services to a large variety of clients, the SEC acknowledges that the duty "follows the contours of the relationship between the adviser and its client" and, provided there is full and fair disclosure and informed consent, this relationship may be shaped by agreement.[58] In particular, the nature of the fiduciary duty will depend on the agreed-upon scope of the client relationship, and the specific obligations that flow from the duty will depend upon the functions the adviser has agreed to provide to its client.[59] For instance, the fiduciary obligations owed to a retail client[60] to provide a single financial plan for a one-time fee may be significantly different than those owed to an institutional client to provide discretionary investment services and ongoing monitoring for an asset-based fee (e.g., an adviser that has been engaged to manage a registered investment company or a private fund). The SEC believes that this principles-based approach provides "sufficient flexibility to serve as an effective standard of conduct for investment advisers, regardless of the services they provide or the types of clients they serve."[61]

While the application of the fiduciary duty is intended to be flexible, when the duty attaches is in some ways less forgiving. For instance, the fiduciary duty, as a component of the Adviser's Act antifraud provisions, applies to all "investment advisers,"[62] whether or not an investment adviser is SEC- or state- registered, or exempt from or not eligible for registration.[63] The duty itself is owed directly to the adviser's client (e.g., *retail and institutional clients*), commencing at the point in time in which a prospective client becomes a client (e.g., upon entering into an advisory agreement), though the

antifraud provisions under Section 206 of the Advisers Act apply to the actions of investment advisers at all times, including while communicating with prospective clients.[64] And, while the fiduciary duty will vary with the agreed-upon scope of the relationship, the duty itself may not be waived.[65] For example, in the Fiduciary Interpretation Release, the SEC notes that any: (i) statement that the investment adviser will not be acting as a fiduciary, (ii) blanket waiver of all conflicts of interest or (iii) waiver of any obligation under the Advisers Act would be inconsistent with the Advisers Act, regardless of the type of client or its sophistication.[66]

C. Duty of Care

As a fiduciary, investment advisers owe their clients a duty of care. As explained in more detail below, this duty includes, among other things,[67] the duty to: (i) provide advice that is in the best interest of the client, (ii) seek best execution of a client's transactions (when the adviser is responsible for the selection of broker-dealers to execute client trades) and (iii) provide advice and monitoring over the course of the relationship.[68]

1. Duty to Provide Advice that Is in the Best Interest of the Client: Investment advisers have a 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."[69] To satisfy this duty, an investment adviser must have both a "reasonable understanding of the client's objectives" and a "reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives."[70]

    a. Reasonable Inquiry into Client's Objectives. How an adviser acquires understanding of its client's objectives will depend on the specific facts and circumstances, including the type of client (retail versus institutional), the scope of the advisory relationship and the nature and complexity of the anticipated investment advice.

    For retail clients, the SEC believes an adviser should, at a minimum, make a "reasonable inquiry into the client's financial situation, level of sophistication, investment experience and financial goals."[71] For a retail client seeking financial planning advice, an adviser is expected to inquire as to the client's current income, investments, assets and debts, marital status, tax status, insurance policies and financial goals (collectively referred to in the Fiduciary Interpretation Release as a client's "investment profile").[72] In order to maintain a reasonable understanding of a client's objectives so that the adviser may modify or adjust the advice to reflect a change in the client's circumstances, advisers to retail clients are expected to update the client's investment profile. The frequency with which an adviser updates a client's investment profile depends on the specific facts and circumstances, including whether the adviser becomes aware of events that could render inaccurate or incomplete the investment profile the adviser relied upon in providing the client with advice.[73] For example, a change in relevant tax law or the adviser's knowledge of a change in work or marital status may require the adviser to make a new inquiry into the client's objectives.

    For institutional clients, the nature and scope of a reasonable inquiry generally depends on the specific client's investment mandate.[74] For example, an investment adviser that is engaged to manage a registered investment company or a private fund is expected to have a reasonable understanding of the fund's investment guidelines and objectives.[75] However, an adviser that is engaged to manage a specific portfolio on behalf of an institutional client will need to understand the client's objectives for such portfolio, but not the client's objectives for its

other investment portfolios.[76] For institutional clients engaging advisers pursuant to specific mandates, the SEC believes the adviser would not have an obligation to update the client's objectives unless such obligation was set forth in the applicable advisory agreement.[77]

b. Reasonable Belief that Advice is In the Best Interest of the Client. At all times an investment adviser must have a "reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives."[78] Forming this reasonable belief involves considering "whether investments are recommended only to those clients who can and are willing to tolerate the risks of those investments and for whom the potential benefits may justify the risks."[79] For instance, high-risk products (e.g., penny stocks or thinly-traded securities) or complex products (e.g., inverse or leveraged exchange-traded products) may be appropriate for some clients, but not others—an adviser is advised to apply heightened scrutiny and daily monitoring in determining whether such products are appropriate for its retail clients.[80] Other important factors the SEC identifies in the Fiduciary Interpretation Release that advisers should consider in making a best interest determination include cost (though the SEC makes clear that the lowest-cost product alone does not satisfy an adviser's fiduciary obligations[81]), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit.[82] The duty to act in the client's best interest extends to all investment advice provided by an adviser, including advice about investment strategy and whether to engage a sub-adviser or to open a certain type of account (e.g., whether to roll over assets from one account to another).[83]

2. Duty to Seek Best Execution: Investment advisers have a duty to seek best execution of a client's transactions when the adviser is responsible for selecting executing broker-dealers.[84] An adviser fulfills this duty by seeking to *maximize the value* for its client when executing securities transactions (determined under the particular circumstances occurring at the time of execution).[85] The SEC is careful to point out that maximizing value includes more than just minimizing costs and advisers are expected to consider the "full range and quality of a broker's services," including value of any research provided, execution capability, fees and other costs, financial responsibility and responsiveness, and should "periodically and systematically" evaluate the execution they are receiving for their clients.[86]

3. Duty to Provide Advice and Monitoring over the Course of the Relationship: Investment advisers have a duty to "provide advice and monitoring at a frequency that is in the best interest of the client, taking into account the scope of the agreed-upon relationship."[87] As suggested above, the agreed-upon scope of the relationship will determine how far an adviser's duty to monitor extends. For example, advisers engaged to provide ongoing investment advisory services for a periodic asset-based fee will have a relatively extensive duty to monitor; whereas, absent an express agreement outlining the adviser's monitoring obligations, when the relationship is of a limited duration (e.g., one-time financial plan for a one-time fee), the adviser is unlikely to have a duty to monitor.[88] Accordingly, advisers should be explicit about the frequency and extent of their monitoring obligations in their advisory agreements.[89] As with the duty to act in a client's best interest, the duty to monitor extends to all personalized advice provided to a client including, as the SEC notes in the Fiduciary Interpretation Release, "in an ongoing relationship, an evaluation of whether a client's account or program type (for example, a wrap account) continues to be in the client's best interest."[90]

D. Duty of Loyalty

As a fiduciary, investment advisers also owe their clients a duty of loyalty. This duty "requires that an adviser not subordinate its clients' interests to its own."[91] In other words, investment advisers must not place their own interests ahead of the interests of their clients. To fulfill this requirement, advisers must comply with the following requirements and obligations:

1. An adviser must provide *full and fair disclosure* to its clients of *all material facts* relevant to the relationship, including the capacity in which the adviser is acting at the time advice is provided.[92] Dual registrants (i.e., investment advisers that also are registered as broker-dealers) should be particularly mindful of this obligation when they provide both investment advisory and brokerage services to the same client, and are advised to disclose any circumstances in which advice will be limited to services or products offered through its affiliated broker-dealer or affiliated investment adviser.[93]

2. An adviser must "*eliminate or at least expose through full and fair disclosure all conflicts of interest* which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[94] Importantly, in a departure from the Proposed Fiduciary Interpretation,[95] where the SEC stated that an adviser must seek to avoid conflicts of interest, the Fiduciary Interpretation Release clarifies that an adviser may fulfill its duty of loyalty by making full and fair disclosure of conflicts of interest and obtaining the client's informed consent.[96] While an adviser does not have a fiduciary obligation to avoid conflicts of interest, the SEC emphasized that advisers *should* seek to avoid conflicts.[97]

3. Satisfaction of an adviser's disclosure obligations and a client's informed consent may satisfy its duty of loyalty; however, by themselves do not satisfy the adviser's obligation to act in the client's best interest—advisers are "prohibited from overreaching or taking unfair advantage of a client's trust."[98]

4. For disclosure to be "full and fair," an adviser should present the client with sufficiently specific facts so that the client is able to understand the material fact or the adviser's conflict of interest and make an informed decision whether or not to provide consent.[99] As with the fiduciary duty generally, whether disclosure is full and fair will depend on the facts and circumstances including, among other things, the nature of the client, the scope of advisory services and the material fact or conflict of interest.[100] Full and fair disclosure may differ between institutional clients and retail clients (including the specificity, level of detail and usage of terminology).[101]

   In its discussion of full and fair disclosure, the Fiduciary Interpretation Release specifically addresses disclosure of two types of conflicts: (i) actual versus potential conflicts of interest and (ii) investment allocations. In the first case, the SEC believes disclosure would be inadequate for an adviser to, without more, indicate that it "may" have a particular conflict of interest if that conflict actually exists.[102] Usage of the term "may," however, could still be appropriate to describe a conflict of interest that does not currently exist, but which, reasonably, may present itself in the future. In the second case, where an adviser faces conflicts of interest in allocating investment opportunities among multiple eligible clients (e.g., as a result of the adviser's compensation arrangements with such clients), the adviser must "eliminate or at least expose through full and fair disclosure the conflicts associated with its allocation policies, including how the adviser will allocate investment opportunities."[103] An adviser is not required to have a pro rata allocation policy (or any particular method of allocation) and is permitted to

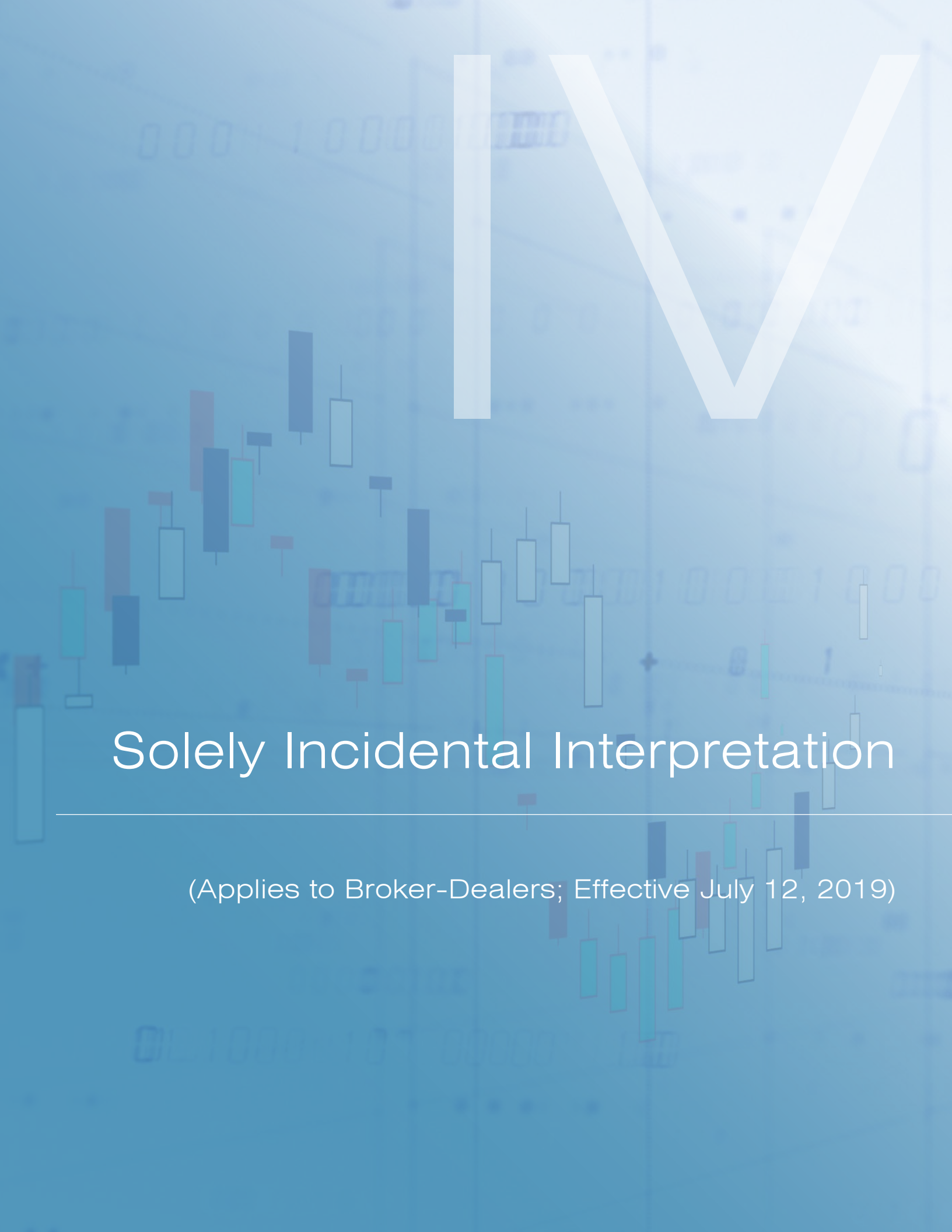
consider the nature and objectives of the client and the scope of the relationship, but the adviser's allocation practices cannot prevent the adviser from providing advice that is in the best interest of its clients.[104]

5. Depending on the facts and circumstances, informed consent may be either explicit or implicit[105] and, although a best practice, neither full and fair disclosure nor informed consent need to be reduced to writing.[106] For example, where there is full and fair disclosure of all material facts relating to the advisory relationship, including all conflicts of interest, through a combination of Form ADV and other forms of disclosure, a client could implicitly consent by entering into or continuing the advisory relationship with the adviser.[107] However, while advisers are not required to make an affirmative determination that a particular client understood the disclosure or that the client's consent was informed, where an adviser is aware (or reasonably should have been aware) that a client did not understand the "nature and import of the conflict," the adviser cannot infer or accept the client's consent.[108]

6. Where an adviser cannot provide full and fair disclosure of a conflict of interest due to the conflict's complexity, such that disclosure would not adequately convey the material factors or the nature, magnitude and potential effect of the conflict, 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."[109]

E. Continuing Evaluation of Comments

The Proposed Fiduciary Interpretation sought comments on three additional enhancements to the legal obligations of SEC-registered investment advisers: (i) federal continuing education and licensing requirements for investment adviser personnel, (ii) advisory client account statement delivery requirements and (iii) investment adviser financial responsibility requirements. In the Fiduciary Interpretation Release, the SEC noted that it is continuing to evaluate the comments it has received in response to its request for comments[110] and has not adopted any changes relating to these proposals at this time.



IV

Solely Incidental Interpretation

(Applies to Broker-Dealers; Effective July 12, 2019)

IV.
SOLELY INCIDENTAL INTERPRETATION
(Applies to Broker-Dealers; Effective July 12, 2019)

A. Overview and Background

The Advisers Act regulates the activity of "investment advisers" as defined thereunder. Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser" broker-dealers "whose performance of such advisory services is *solely incidental* to the conduct of [its] business as a broker or dealer *and who receives no special compensation therefor*" (the solely incidental prong being referred to as the "Exclusion").[112] In recognition of the fact that broker-dealers are permitted to provide certain "advisory services" in connection with their brokerage businesses,[113] the SEC published the Solely Incidental Interpretation to clarify its interpretation of the Exclusion.[114] The Solely Incidental Interpretation supersedes any inconsistent prior SEC interpretations relating to the Exclusion.[115]

In general, the SEC believes advice provided by a broker-dealer falls within the Exclusion if "the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[116] Ultimately, whether advice provided by a broker-dealer complies with the Exclusion is based on the facts and circumstances surrounding the broker-dealer's business, services offered and the broker-dealer's relationship with its customer.[117] Notably, the SEC believes the "quantum or importance" of the investment advice is not decisive as to whether or not the advice meets the Exclusion, and the SEC goes on to state "[a]dvice need not be trivial, inconsequential, or infrequent to be consistent with the solely incidental prong."[118] As discussed below, the Solely Incidental Interpretation provides guidance on how the Exclusion applies when broker-dealers: (i) exercise investment discretion and (ii) engage in account monitoring.[119]

B. Investment Discretion

The SEC believes that when a broker-dealer has discretion over a customer's account, the relationship has "many of the characteristics of the relationship to which the protections of the Advisers Act are important"[120] and, although unlimited investment discretion over a customer's account would not fall within the Exclusion, the SEC has taken the position that temporary or limited discretionary authority could be considered solely incidental to the broker-dealer's business and, thus, within the Exclusion.[121]

While the SEC will consider the totality of the circumstances in determining whether temporary or limited discretion is indicative of a relationship that is primarily advisory in nature, situations in which discretion is limited in time, scope or other manner lacking a "comprehensive and continuous character of investment discretion" generally suggest the relationship is not primarily advisory.[122] The SEC provided the following examples of temporary or limited investment discretion that would typically qualify as being within the scope of the Exclusion:

- discretion as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security;

- discretion, on an isolated or infrequent basis, to purchase or sell a security or type of security when a customer is unavailable for a limited period of time;
- discretion as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent;
- discretion to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified;
- discretion to sell specific bonds or other securities and to purchase similar bonds or other securities in order to permit a customer to realize a tax loss on the original position;
- discretion to purchase a bond with a specified credit rating and maturity; and
- discretion to purchase or sell a security or type of security limited by specific parameters established by the customer.[123]

C. Account Monitoring

In disagreeing with some commenters, the SEC does not believe that any amount of customer account monitoring would be inconsistent with the Exclusion.[124] While the SEC declines in the Solely Incidental Interpretation Release to provide every example where agreed-upon monitoring complies with the Exclusion, the SEC notes that where a broker-dealer agrees to "monitor a retail customer's account on a periodic basis for purposes of providing buy, sell, or hold recommendations" such agreement may be considered providing advice in connection with its primary business of buying and selling securities within the meaning of the Exclusion.[125] Similarly, where a broker-dealer voluntarily and without any agreement to do so reviews a retail customer's account for the purpose of providing a recommendation, even if the broker-dealer contacts the customer to communicate its recommendation, the SEC believes the broker-dealer's actions are related to its primary business and eligible for the Exclusion.[126]

The SEC recommends that broker-dealers adopt policies and procedures to help navigate when agreed-upon monitoring falls within the Exclusion, providing, for example, that registered representatives may agree to monitor customer accounts at specific time frames (e.g., quarterly) for purposes of determining whether to provide buy, sell or hold recommendations and forbidding continuous monitoring.[127] Such policies and procedures are especially encouraged for dually registered firms to distinguish the level and type of monitoring of advisory and brokerage accounts.

CONCLUSION

The rules and interpretations of the June 5 Release establish new standards for investor protection. Investment advisers, broker-dealers and their financial professionals should thoroughly consider whether they are subject to these new standards and, if so, how they will achieve compliance through their processes and procedures. Finally, firms that are subject to Reg BI and/or Form CRS should be especially mindful of the upcoming June 30, 2020 compliance date, particularly those broker-dealer firms that interact with retail clients.

ABOUT THE INVESTMENT SERVICES GROUP

The Investment Services group at Vedder Price has experience in all matters related to the design, organization and distribution of investment products. We can assist with investment company and investment adviser securities regulation and compliance matters, derivatives and financial product matters, and ERISA and tax matters.

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END NOTES

1 Adopting Release 34-86031 (June 5, 2019) (the "Reg BI Release") at 17, available at https://www.sec.gov/rules/final/2019/34-86031.pdf.

2 Reg BI Release at 20.

3 *Id.* at 5.

4 *Id.* at 129.

5 *Id.* at 77.

6 *Id.* at 43.

7 *Id.* at 79.

8 *Id.* at 89-91.

9 The Reg BI Release states that a retail customer "uses" a recommendation when, as a result of the recommendation, (i) the retail customer opens a brokerage account with the broker-dealer, regardless of whether the broker-dealer receives compensation, (ii) the retail customer has an existing account with the broker-dealer and receives a recommendation from the broker-dealer, regardless of whether the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation or (iii) the broker-dealer receives or will receive compensation, directly or indirectly, as a result of that recommendation, even if that retail customer does not have an account at the firm. *See id*. at 99 n.202.

10 Reg BI Release at 115.

11 Additional examples of "nonprofessional legal representatives" would include executors, conservators and persons holding a power of attorney for a natural person. *See id.* at 114.

12 *Id.* at 112.

13 *Id.* at 114.

14 For a discussion on the limited circumstances in which the Disclosure Obligation could be satisfied either after the transactions or orally, see id. at 137-39. If the Disclosure Obligation is satisfied orally, a broker-dealer must maintain a written record that such disclosure occurred. *See id*. at 229.

15 *Id.* at 149.

16 *Id.* at 169.

17 For examples and additional analysis, *see id.* at 173.

18 This could include, for example, recommending only (i) proprietary products, (ii) a specific asset class, (iii) products with third-party arrangements (e.g., revenue sharing and mutual fund service fees), (iv) products from a select group of issuers or (v) making IPOs available only to certain clients. *Id.* at 179.

19 This disclosure should also address circumstances in which the "general basis" does not apply and how the broker-dealer will notify the customer when that is the case. *Id.* at 188-89.

20 The term "conflict of interest" is defined as "an interest that might incline a broker, dealer or natural person who is an associated person of a broker or dealer—consciously or unconsciously—to make a recommendation that is not disinterested." *Id.* at 199.

21 For a greater discussion on proper disclosure of compensation, see id. at 203-06.

22 Disclosure of material facts relating to conflicts of interest involving proprietary products could include "that the relevant broker-dealer owns the product, and that in addition to any commission associated with the product, the broker-dealer or an affiliate may receive additional fees and compensation related to the product." *Id.* at 209.

23 *Id.* at 225.

24 *Id.* at 244.

25 *Id.* at 247.

26 *Id.* at 262.

27 *Id.* at 262. For a discussion of factors to be considered when recommending a variable annuity, *see id.* at 271.

28 *Id.* at 266.

29 A retail customer's investment profile would need to be developed by the broker-dealer and take into account factors such as age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs and risk tolerance. In gathering information about a retail customer's investment profile, a broker-dealer

may rely on a customer's responses absent any red flags that would indicate the information is misleading. *See id.* at 273. For a discussion of factors to be considered when recommending a specific account type (brokerage, advisory or other account offered by a broker-dealer), *see id.* at 292. For a discussion of factors to be considered when recommending the rolling over of assets to an IRA, *see id.* at 296.

30 *Id.* at 284-85.

31 *Id.* at 39.

32 *Id.* at 290-91.

33 *Id.* at 301.

34 The Reg BI Release stated that reasonably designed policies and procedures to identify conflicts of interest should generally do the following: (i) define such conflicts in a manner that is relevant to a broker-dealer's business (i.e., conflicts of both the broker-dealer entity and the associated persons of the broker-dealer) and in a way that enables employees to understand and identify conflicts of interest, (ii) establish a structure for identifying the types of conflicts that the broker-dealer (and associated persons of the broker-dealer) may face, (iii) establish a structure to identify conflicts in the broker-dealer's business as it evolves, (iv) provide for an ongoing (e.g., based on changes in the broker-dealer's business or organizational structure, changes in compensation incentive structures, and introduction of new products or services) and regular, periodic (e.g., annual) review in order to identify conflicts associated with the broker-dealer's business and (v) establish training procedures regarding the broker-dealer's conflicts of interest, including conflicts involving natural persons who are associated persons of the broker-dealer, such as how to identify such conflicts of interest, as well as defining employees' roles and responsibilities with respect to identifying such conflicts of interest. *See id.* at 315-16.

35 The Reg BI Release provided the following specific examples of broker-dealer incentives that would need to be addressed by a firm's policies and procedures: (i) compensation from the broker-dealer or from third parties, including fees and other charges for the services provided and products sold, (ii) employee compensation or employment incentives (e.g., incentives tied to asset accumulation, special awards, differential or variable compensation, or incentives tied to appraisals or performance reviews) and (iii) commissions or sales charges, or other fees or financial incentives, or differential or variable compensation, whether paid by the retail customer, the broker-dealer or a third party. Such examples focus on compensation that varies based on the advice given, such as commissions, markups/markdowns, loads, revenue sharing and Rule 12b-1 fees. *See id.* at 330.

36 Such mitigation methods include the following: (i) avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales, (ii) minimizing compensation incentives for employees to favor one type of account over another, or to favor one type of product over another, proprietary or preferred-provider products, or comparable products sold on a principal basis for example, by establishing differential compensation based on neutral factors, (iii) eliminating compensation incentives within comparable product lines by, for example, capping the credit that an associated person may receive across mutual funds or other comparable products across providers, (iv) implementing supervisory procedures to monitor recommendations that are near compensation thresholds; are near thresholds for firm recognition; involve higher compensating products; proprietary products or transactions in a principal capacity; or involve the rollover or transfer of assets from one type of account to another (such as recommendations to rollover or transfer assets in an ERISA account to an IRA) or from one product class to another, (v) adjusting compensation for associated persons who fail to adequately manage conflicts of interest and (vi) limiting the types of retail customers to whom a product, transaction or strategy may be recommended. *See id.* at 334-36.

37 The Reg BI Release did not specifically define "a limited period of time" but it did provide guidance the rule is "concerned about time limitations that create high-pressure situations for associated persons to increase the sales of specific securities or specific types of securities which compromise the best interests of their customers." *See id.* at 355 n.801.

END NOTES

38 *Id.* at 352.

39 *Id.* at 360.

40 The Reg BI Release further noted that Reg BI would not apply "even if the retail customer has a brokerage relationship with the dual registrant or the dual registrant executes the transaction in its brokerage capacity." *See id.* at 126.

41 *Id.* at 127.

42 *Id.* at 366-67.

43 *Id.* at 607.

44 *Id.* at 719.

45 Adopting Release 34-86032 (June 5, 2019) ("Form CRS Release") at 17, available at https://www.sec.gov/rules/final/2019/34-86032.pdf. Note the term "retail investor" is largely conformed to the definition of "retail customer" in Reg BI. *See* Form CRS Release at 189-201.

46 Dual registrants that prepare separate relationship summaries for their brokerage and advisory services are limited to two pages each, or the equivalent if delivered electronically. See id. at 48.

47 *Id.* at 24.

48 *Id.* at 188.

49 *Id.* at 514.

50 *Id.* at 479.

51 *Id.* at 500.

52 Adopting Release IA-5248 (June 5, 2019) ("Fiduciary Interpretation Release") at 1, *available at* https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

53 *Id.* at 29.

54 In relevant part, Sections 206(1) and (2) of the Advisers Act state: "It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—(1) To employ any device, scheme, or artifice to defraud any client or prospective client; [or] (2) To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." See 15 U.S.C. § 80b-6(1) and (2).

55 Fiduciary Interpretation Release, *supra* note 52, at 6.

56 *Id.* at 6, 9.

57 *Id.* at 5, 7.

58 *Id.* at 9.

59 *Id.* at 9-10.

60 Unlike in Reg BI ("retail customer") and Form CRS ("retail investor"), the Fiduciary Interpretation Release does not define "retail client." A consistent reading of the Reg BI Rules would suggest that "retail client" means a natural person, who seeks to receive or receives advisory services primarily for personal, family or household purposes, without regard to net worth or financial sophistication.

61 Fiduciary Interpretation Release, *supra* note 52, at 9.

62 In relevant part and subject to certain prescribed exclusions, the Advisers Act defines an "investment adviser" as any "person who, *for compensation*, engages in the *business of advising others*, either directly or through publications or writings, as to the *value of securities or as to the advisability of investing in, purchasing, or selling securities*, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." *See* 15 U.S.C. § 80b-2(a)(11) (emphasis added).

63 Fiduciary Interpretation Release, supra note 52, at 2-3. n.3.

64 *Id.* at 18 n.42.

65 *Id.* at 10. *See*, also, Section 215(a) of the Advisers Act which provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Advisers Act] or with any rule, regulation, or order thereunder shall be void." 15 U.S.C. § 80b-15.

66 *Id.* at 10-11. In a Fiduciary Interpretation Release footnote, the SEC expressed its concern over the inclusion in advisory agreements of so-called "hedge clauses"—those clauses that purport to limit the liability of investment advisers except in connection with certain prescribed conduct (e.g., gross negligence, will misconduct etc.)—after the SEC issued the Heitman Capital

Management, LLC, SEC Staff No-Action Letter (Feb. 12, 2007), which the SEC expressly withdraws in the Fiduciary Interpretation Release. *Id.* at 11 n.31. In particular, the SEC believes "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 law." *Id.* The SEC reasons "[s]uch 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." *Id.* Whether similar hedge clauses included in institutional client advisory agreements violate the Advisers Act's antifraud provisions will be determined based on the particular facts and circumstances. *Id.* As a result, investment advisers are urged (with the assistance of counsel) to reevaluate the wording of any hedge clauses included in their advisory contracts (in particular, for retail clients) and to consider revising such language where it may be read to imply a waiver of any non-waivable provisions of federal or state law.

67 Of note, the Fiduciary Interpretation Release does not indicate what these other duties may include.

68 *Id.* at 12.

69 *Id.* (emphasis added).

70 *Id.* at 13, 15.

71 *Id.*

72 *Id.* at 13-14.

73 *Id.* at 14.

74 *Id.*

75 *Id.* at 15.

76 *Id.* at 14-15.

77 *Id.* at 15.

78 *Id.* at 15, 18.

79 *Id.* at 15. To satisfy the adviser's fiduciary obligations, an adviser must conduct reasonable diligence into each investment so as not to base its advice on materially inaccurate or incomplete information. The SEC notes in the Fiduciary Interpretation Release that it has taken enforcement action where an investment adviser did not independently or reasonably investigate an investment before recommending it to its clients. *Id.* at 16.

80 *Id.* at 16.

81 The SEC acknowledges that a higher-cost investment or strategy may be appropriate if the costs are reasonably outweighed by other factors and includes an example in the Fiduciary Interpretation Release of a client with a high risk tolerance and significant investment experience investing in a private equity fund with relatively high fees and significantly less liquidity than an investment in a fund that invests in publicly-traded securities, provided the investment in the private equity fund is in the best interest of the client, for example, because it provided exposure to a specific asset class that was appropriate in view of the client's overall portfolio. *Id.* at 17.

82 *Id.* at 17.

83 *Id.* at 18. The SEC believes this duty also requires an adviser to consider all types of accounts offered by the adviser and to acknowledge whether any such accounts are not in the client's best interest. *Id.*

84 *Id.* at 19.

85 *Id.*

86 *Id.* at 19-20.

87 *Id.* at 20.

88 *Id.* at 21.

89 Advisers are also encouraged to develop written policies and procedures relating to monitoring when appropriate under Advisers Act Rule 206(4)-7.

90 *Id.*

91 *Id.*

92 *Id.* at 21-22.

93 *Id.* at 22.

94 *Id.* at 23 (emphasis added).

END NOTES

95 *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. 4889 (Apr. 18, 2018) (the "Proposed Fiduciary Interpretation").

96 Fiduciary Interpretation Release, *supra* note 52, at 23 n.57.

97 *Id.*

98 *Id.*

99 *Id.* at 24.

100 *Id.* at 25.

101 *Id.*

102 *Id.*

103 *Id.* at 26.

104 *Id.* at 26-27.

105 *Id.* at 27.

106 *Id.* at 27 n.68.

107 *Id.*

108 *Id.* at 27.

109 *Id.* at 28 (emphasis original).

110 *Id.* at 4 n.8.

111 *See supra* note 62.

112 *See* 15 U.S.C. § 80b-2(a)(11)(C) (emphasis added).

113 Adopting Release IA-5249 (June 5, 2019) ("Solely Incidental Interpretation Release") at 1, *available at* https://www.sec.gov/rules/interp/2019/ia-5249.pdf. The Solely Incidental Interpretation Release makes clear that Congress, the courts and the SEC believe broker-dealers may provide certain investment advice in connection with their business to buy and sell securities.

114 *See* Solely Incidental Interpretation Release, supra note 113. While both prongs of the broker-dealer exclusion must be met (i.e., services must be solely incidental to broker-dealer activities and the broker-dealer must not receive special compensation for such services), the Solely Incidental Interpretation only addresses the solely incidental prong.

115 *Id.* at 12 n.46.

116 *Id.* at 12.

117 *Id.* at 13.

118 *Id.*

119 The SEC notes that investment discretion and account monitoring cannot be viewed and interpreted in isolation. Thus, compliance with one does not imply compliance with the other or with the Exclusion, and policies and procedures should be adopted to address both situations. *See Id.* at 21 n.71.

120 *Id.* at 14.

121 *Id.* at 16.

122 *Id.* at 16-17.

123 *Id.* at 17.

124 *Id.* at 19.

125 *Id.* at 19-20. Note, however, that any agreement to monitor a retail customer's account on a periodic basis triggers compliance with Reg BI's obligations to review and make recommendations (e.g., to buy, sell or hold) with respect to that account on the agreed-upon periodic basis, even where no recommendation is communicated to the customer (i.e., an implicit hold recommendation).

126 *Id.* at 20. The SEC goes on to state "[a]bsent an agreement with the customer . . . we do not consider this voluntary review to be 'account monitoring.'" *Id.*

127 *Id.* at 21.

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