

May 1, 2018

## SEC Releases Proposed Adviser Conduct Standard and Request for Comment on Enhancing Adviser Regulations

On April 18, 2018, the SEC issued a release (the “Release”), entitled, “Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers” (the “Adviser Conduct Proposal”), along with a request for comment on “Enhancing Investment Adviser Regulations.” The Release was issued in connection with two proposed rules that came out the same day: (1) the proposed “Regulation Best Interest” under the Securities Exchange Act of 1934 for broker-dealers, and (2) a proposed Form Client Relationship Summary for retail clients of both investment advisers and broker-dealers.

All investment advisers subject to the Advisers Act, including wealth managers, institutional shops, and private fund advisers, should take notice of the Adviser Conduct Proposal, as it seeks to consolidate in one place the salient attributes of the federal fiduciary standard applicable to investment advisers.

This Alert summarizes the Adviser Conduct Proposal, identifies certain aspects of the Adviser Conduct Proposal that we anticipate will generate significant interest and industry comment during the review period, and concludes by summarizing the request for comment on Enhancing Investment Adviser Regulations. We will provide a separate alert addressing Regulation Best Interest and the proposed Form Client Relationship Summary in the near future.

### I. Summary of the Adviser Conduct Proposal

The stated objective of the Adviser Conduct Proposal is “to reaffirm – and in some cases clarify – certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act.” Thus, the Adviser Conduct Proposal is not intended to create new or different obligations or requirements, but rather is an attempt to gather in one place existing components of the Advisers Act fiduciary duty.

The Adviser Conduct Proposal reaffirms that the Advisers Act fiduciary duty derives from common law principles. It draws heavily from *SEC v. Capital Gains Research Bureau, Inc.*, the 1963 Supreme Court opinion commonly cited for having held that the Advisers Act imposes a fiduciary standard on registered investment advisers. The Adviser Conduct Proposal describes a two-pronged fiduciary standard that includes (1) a duty of care and (2) a duty of loyalty.

- **Duty of Care**

- The Adviser Conduct Proposal describes the duty of care as consisting of (i) the duty to act and provide advice that is in the best interest of the client, (ii) the duty to seek best execution of a client’s transactions, and (iii) the duty to provide advice and monitoring.
- The duty of care described in the Adviser Conduct Proposal requires an investment adviser to “make a reasonable inquiry into a client’s financial situation, level of financial sophistication, investment experience, and investment objectives . . . and a duty to provide personalized investment advice that is suitable for and in the best interest of the client based on the client’s investment profile.” The Adviser Conduct Proposal also states that such profile must be updated

from time to time, but is unclear regarding the extent to which an adviser has an affirmative duty to inquire regarding changed circumstances of the client.

- The Adviser Conduct Proposal states that the cost of investment advice, including the cost of fees or compensation, would generally be an important factor that an investment adviser should consider when determining whether a security or strategy is in the best interest of a client. While the Release makes clear that other factors are also important, the Adviser Conduct Proposal may trigger additional review of fees and costs through a fiduciary lens.
  - The Adviser Conduct Proposal confirms investment advisers' existing obligations with respect to best execution as set forth in existing SEC guidance.
  - The Adviser Conduct Proposal states that an investment adviser must provide monitoring and advice at a frequency that is in the best interest of the client and consistent with the scope of services agreed to by the client and the adviser.
- **Duty of Loyalty**
    - The Adviser Conduct Proposal describes the duty of loyalty as requiring that an investment adviser must put its clients' interests ahead of its own, must not unfairly favor one client over another, and must make full and fair disclosure of all material facts relating to the advisory relationship.
    - The Adviser Conduct Proposal also states that an investment adviser "must seek to avoid conflicts, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship."
    - In line with past enforcement actions, the Adviser Conduct Proposal confirms that an investment adviser may not favor proprietary accounts over client accounts (for example, in connection with allocations of investment opportunities) and may not favor certain client accounts that pay higher fee rates over other client accounts.
    - The Adviser Conduct Proposal also emphasizes the need for disclosure to be clear and understood by clients in order to satisfy Section 206 and the duty of loyalty. Disclosure must be sufficiently specific so that a client is able to understand the adviser's conflicts of interest and business practices well enough to make an informed decision (e.g., the SEC states that disclosure that a conflict "may" exist is not sufficient if the conflict actually exists). A client's informed consent can be either explicit or, depending on the facts and circumstances, implicit (although an adviser cannot infer consent if the facts and circumstances indicate that the client did not understand the nature and import of the conflict, i.e., the sophistication of the client matters). The SEC also noted that there may be circumstances with some complex or extensive conflicts where it may be difficult to provide disclosure that is sufficiently specific, but also understandable to clients.

## II. Initial Observations on the Adviser Conduct Proposal

As noted above, the Adviser Conduct Proposal is intended to reaffirm and clarify the Advisers Act fiduciary duty, rather than create a new duty that did not exist under prior law. Much of the Adviser Conduct Proposal therefore consists of citations and recapitulations of well-settled principles. However, we anticipate that certain statements in the Adviser Conduct Proposal will draw close scrutiny and comment during the 90-day review period established by the Commission for the proposal.

We expect that industry commenters will seek clarification in particular on the extent to which investment advisers may satisfy their fiduciary duty through full and fair disclosure to their clients. The Adviser Conduct Proposal is ambiguous on this point. Specifically, it states that an investment adviser “cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty” and 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,” and contemplates that there may be cases “where full and fair disclosure and informed consent is insufficient,” although the discussion accompanying these statements focuses on the quality of disclosure and whether an investor understood it, rather than whether an adviser can act in its own interest if such interest is properly disclosed. We do not believe the Commission intended the Adviser Conduct Proposal to signal a fundamental shift in their understanding of disclosure and informed consent as a means to address adviser conflicts, but clarity on this question would be welcome.

We also expect that industry commenters will seek clarification regarding the application of these standards to private funds and private fund investors. Although the Adviser Conduct Proposal is not addressed specifically to any one type of client relationship, many portions of the proposal seem to have been written primarily with separately managed account clients in mind.

### III. Request For Comment on Enhanced Investment Adviser Regulation

In addition to setting forth the SEC’s interpretation of the fiduciary standard applicable to investment advisers, the Release also requests comments on three discrete proposals, all of which are derived from regulations currently applicable to broker-dealers:

- **Federal Licensing and Continuing Education:** The federal securities laws do not impose licensing or qualification requirements on investment advisers, though FINRA imposes such requirements on associated persons of broker-dealers. The SEC has requested comment on whether there should be federal licensing, qualification, and continuing education requirements for investment adviser representatives.
- **Provision of Account Statements:** The federal securities laws do not require investment advisers to provide clients with account statements, though we believe that most advisers do so. The SEC has requested comment on whether advisers should be required to provide account statements setting forth the fees and expenses charged for advisory services.
- **Financial Responsibility:** While Rule 206(4)-2 under the Advisers Act requires investment advisers with custody over client assets to maintain such assets with a qualified custodian, the federal securities laws do not impose capital requirements on investment advisers or require investment advisers to maintain a fidelity bond. Accordingly, the SEC has requested comment on whether investment advisers should be subject to financial responsibility requirements similar to those that apply to broker-dealers.

Industry comments on these potential regulations will be helpful. For example, insights from dual-registered advisers in the U.S., insights from registered advisers that are regulated under other regimes that impose similar requirements, insights from asset management firms describing potential burdens compared to potential benefits to clients, and insights from different types of advisory firms (institutional, retail, private fund advisers, and others) that may be differently impacted by these types of requirements would be helpful in addressing these potential new regulatory proposals.

### IV. Comment Period

Comments may be submitted on the Adviser Conduct Proposal and the Enhanced Investment Adviser Regulation for 90 days following publication in the Federal Register. We expect that the other rules proposed by the Commission will be controversial, based on the statements of the Commissioners at the April 18 open meeting. Thus, it is difficult

to predict how soon the Commission may act on these proposals after the 90-day comment period, and whether the Commission may consider approving any of the proposals separately. We will keep you apprised of developments regarding the proposals.