June 12, 2019

SEC Releases Final Interpretation on Adviser Conduct Standard and Fiduciary Duty

On June 5, 2019, the SEC held an open meeting and issued a long-awaited final interpretation entitled "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (the "Final Guidance"). The Final Guidance was issued in connection with another interpretation entitled "Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser," as well as two final rules: "Form CRS Relationship Summary; Amendments to Form ADV" and "Regulation Best Interest: The Broker-Dealer Standard of Conduct." These companion releases will be addressed in separate Ropes & Gray Alerts.

The Final Guidance provides clarifications that address comments received following the SEC's April 18, 2018 proposed guidance related to the standard of conduct for investment advisers under the Advisers Act (the "Proposed Guidance"). We issued a Ropes & Gray Alert summarizing the Proposed Guidance, and submitted a comment letter (the "Comment Letter") to the SEC in August of 2018 seeking clarification to certain aspects of the Proposed Guidance.

All investment advisers subject to the Advisers Act, including private fund advisers, wealth managers, and institutional and retail advisers, should take notice of the Final Guidance, as it seeks to consolidate in one place the salient attributes of the federal fiduciary standard applicable to investment advisers. This Ropes & Gray Alert summarizes the Final Guidance, and identifies changes from the Proposed Guidance that we anticipate will generate significant interest.

Summary of the Final Guidance and Observations

The stated objective of the Final Guidance 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." The Final Guidance 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. As a result, much of the Final Guidance consists of citations and recapitulations of well-settled principles. The SEC received over 150 comment letters on the Proposed Guidance. The SEC opted for "guidance" and declined to propose any specific rule text, stating its belief that the principles-based approach to the relationship between an investment adviser and clients, rooted in fiduciary principles, "should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services."

The Final Guidance reaffirms and clarifies the disclosure-based Advisers Act fiduciary duty that is derived from common law principles, drawing 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 disclosure-based fiduciary standard on registered investment advisers. In short, a "disclosure-based" fiduciary duty is a duty an adviser has to its clients that is circumscribed by the advance disclosure that the adviser gives to its clients. While the Final Guidance includes statements that could be read to suggest that an adviser must act in the best interests of a client regardless of disclosure (a concern raised by the Proposed Guidance), ultimately the language of the Final Guidance strongly supports the reaffirmation of the "disclosure-based" fiduciary duty. In the Final Guidance, the SEC eliminates most of the references to a "best interest" standard that created confusion from the Proposed Guidance, and instead clarifies that investment advisers have a duty to "eliminate, or at least to expose, all conflicts which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."

The Final Guidance describes a long-established two-pronged fiduciary standard that includes (1) a duty of care and (2) a duty of loyalty. Additionally, the Final Guidance clarifies the application of that fiduciary duty, as defined by the scope of a relationship between an investment adviser and its client.

- **Application of Duty**
  - The Final Guidance notes that an adviser's fiduciary duty "follows the contours of the relationship between the adviser and its client, and the adviser and its clients may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent." While acknowledging that all investment advisers owe their clients a fiduciary duty, the SEC also acknowledges that advisers serve a varied spectrum of clients, from retail clients with "limited assets and investment knowledge and experience" to institutional clients with "substantial knowledge, experience and analytical resources." The Final Guidance thus clarifies that the fiduciary duty "must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client" and that an adviser's fiduciary duty depends largely on what functions it has agreed to perform for its clients.
  - In particular, the Final Guidance distinguishes between the obligations of an adviser providing "comprehensive, discretionary advice" in a retail client relationship and the obligations of an adviser to a registered investment company or private fund, where a negotiated contract defines the scope of services and limitations authority.
  - The Final Guidance reaffirms that an adviser's fiduciary duty to its clients may not be waived. It cites several examples of unacceptable waivers of the fiduciary duty, such as:
    1. A statement that the adviser will not act as a fiduciary.
    2. A blanket waiver of all conflicts of interest.
    3. A waiver of any specific obligation under the Advisers Act.
  - The Final Guidance includes a discussion regarding the inclusion of clauses that purport to limit an adviser's liability under an advisory agreement (i.e., a "hedge clause"). The Final Guidance does not address the scope or substance of any fiduciary duty that applies to an adviser under applicable state law, but states that whether a "hedge clause" violates the Advisers Act antifraud provisions is a facts-and-circumstances test – depending largely on the sophistication of the client. For instance, the SEC explains that there are few (if any) circumstances in which a "hedge clause" in an advisory agreement with a retail client would be consistent with antifraud provisions, whereas the determination of whether the same clause in an advisory agreement with an institutional client would violate antifraud provisions would be based on the particular facts and circumstances.
- **Duty of Care**
  - Consistent with the Proposed Guidance, the Final Guidance 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 the client's transactions, and (iii) the duty to provide advice and monitoring.
  - The duty of care described in the Final Guidance requires an investment adviser to "have a reasonable understanding of the client's objectives" in order to provide advice that is in the best interests of its clients. The Final Guidance distinguishes between retail clients, for whom a reasonable understanding of the investment profile is expected, and institutional clients, for whom an understanding of an investment mandate is expected. Specifically, the SEC clarifies that an adviser that formulates a "comprehensive financial plan" for a retail client would need to obtain a range of information about the client (including, for example, assets and debt, tax status, marital status, and financial goals, among other factors). By contrast, an

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investment adviser to a registered investment company or a private fund would need a "reasonable understanding of the fund's investment guidelines and objectives." *How* an adviser develops the appropriate understanding varies "based on the specific facts and circumstances, including the nature of the client, the scope of the adviser-client relationship, and the nature and complexity of the anticipated investment advice."

- The Final Guidance notes that an adviser should update a client's investment profile to maintain its understanding and accordingly adjust advice to reflect changed circumstances. The SEC again distinguishes the expectation for advice to retail and institutional clients, noting that the nature and extent of a reasonable inquiry into a client's objectives "generally is shaped by the specific investment mandates." The SEC notes that for advisers to institutional clients, particularly private funds, "the obligation to update the client's objectives would not be applicable," except as may be set forth in the applicable advisory agreement.

- The Final Guidance further states that an adviser must have a "reasonable belief" that its advice is in the best interest of the client based on that client's objectives. Forming this belief is dependent on the risk profile of the client, and the costs associated with the advice. However, the Final Guidance notes that cost, including fees and compensation, is one of multiple factors to consider (among others, including a product's investment objectives, liquidity, risks, and cost of exit) when determining whether a product or strategy is in the best interest of the client. Notably, the Final Guidance distinguishes between retail clients and institutional clients, stating that it may be appropriate for sophisticated clients to invest in higher risk, higher expense products in light of the objectives of those clients.

- The Final Guidance confirms investment advisers' existing obligations with respect to best execution that is set forth in existing SEC guidance.

- The Final Guidance 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. Where an adviser has an ongoing relationship and is compensated with a periodic "asset-based fee," then the duty to provide ongoing advice and monitoring will be extensive, consistent with the scope of the adviser's relationship with the client.

- **Duty of Loyalty**

  - The Final Guidance reaffirms that an investment adviser can satisfy its duty of loyalty through disclosure. In particular, while the SEC describes the duty of loyalty as a requirement that an investment adviser must put its clients' interests ahead of its own, the Final Guidance further clarifies that "[t]o meet its duty of loyalty, an adviser must make full and fair disclosure of all material facts relating to the advisory relationship."

  - The Final Guidance states that an investment 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," and "an adviser may satisfy its duty of loyalty by making full and fair disclosure of conflicts of interest and obtaining the client's informed consent." In fact, the Final Guidance goes even further on this point, explaining that elimination of a conflict is merely "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" and that "any potential costs or market effects resulting from investment advisers addressing conflicts of interest may be decreased by the flexibility advisers have to meet their federal fiduciary duty in the context of the specific scope of services that they provide to their clients."

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- The SEC notes that, while the General Instruction 3 to Part 2 of Form ADV requires that an adviser "seek to avoid conflicts of interest … *and*, at a minimum, make full disclosure of all material conflicts of interest…[emphasis added]," such a standard is not inconsistent with the Final Guidance standard. The Final Guidance clarifies in a footnote that the standard set forth in the Instruction is reflective of the SEC's and Congress's intent that an adviser eliminate, or at least expose, all conflict of interests (i.e., "seek to avoid" means an adviser must either eliminate *or* disclose conflicts of interest).

- Regarding disclosure, the Final Guidance provides additional guidance regarding (i) the appropriate level of specificity, and (ii) considerations for disclosure regarding conflicts as to allocation of investment opportunities.

    - *Specificity*. Disclosure should "be 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." For example, the Final Guidance notes that it would be inadequate to disclose that the adviser has "other clients" without describing how the adviser will manage conflicts between clients or to disclose that the adviser has "conflicts" without further description.

        - Use of "may". The use of "may" is not adequate in a disclosure when a conflict of interest actually exists. Similarly, the use of "may" is inappropriate preceding a list of all potential or possible conflicts, regardless of likelihood. However, in response to a request in our Comment Letter, the SEC clarified that "may" could be appropriately used to disclose a potential conflict that does not presently exist, but could reasonably occur in the future.

        - Scope. Whether disclosure is full and fair depends on the nature of the client, scope of services, and the conflict itself. The Final Guidance recognizes that institutional clients generally have greater capacity and more resources than retail clients to analyze and understand complex conflicts and their consequences and, therefore, a retail client may require a more extensive explanation than an informed and sophisticated client.

    - *Allocation of Investment Opportunities*. In the Proposed Guidance, the SEC stated that "in allocating investment opportunities among eligible clients, an adviser must treat all clients fairly." However, noting that this language could lead to some misinterpretations that were inconsistent with the "full and fair disclosure" standard applicable to other conflicts, the Final Guidance has removed the sentence and replaced it with a discussion consistent with treatment of other conflicts. Specifically, the Final Guidance notes that, while an adviser need not have *pro rata* or other prescribed allocation methodologies, conflicts relating to allocation, similar to other conflicts, must be eliminated or exposed through full and fair disclosure. As requested in our Comment Letter, the SEC also adds that an adviser and a client may even agree that certain investment opportunities or categories of investment opportunities will not be allocated or offered to a client.

- **Informed Consent**

    - The Final Guidance provides insight on the use of "informed" to describe consent to a conflict. In a significant explanation, the Final Guidance states that an adviser is not required "to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed." Instead, the adviser must ensure that disclosure is "designed to put a client in a position to be able to understand and provide informed consent to the conflict of interest." Consistent with the Proposed Guidance, the SEC states that a client's informed consent can be either explicit or, depending on the facts and circumstances, implicit. However, an adviser cannot infer consent if the facts and circumstances indicate that the client did not understand the nature and import of the conflict, suggesting that the level of sophistication of the client may appropriately inform an adviser's approach to the required consent threshold.

- The Final Guidance also notes 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; however, in a departure from the Proposed Guidance, the SEC strongly suggests that this concern only applies to retail clients. In situations where an adviser cannot fully and fairly disclose a conflict of interest and obtain informed consent, the adviser "should either *eliminate* the conflict or adequately *mitigate*" the conflict to put the client in a position to be able to give informed consent.

- Further, the Final Guidance notes that full and fair disclosure may be made by a combination of Form ADV and other disclosure, such that the client "could implicitly consent by entering into or continuing the investment advisory relationship with the adviser."

Enhanced Adviser Regulation

In the Proposed Guidance, the SEC asked for comment regarding certain possible enhancements including, for instance, with respect to federal licensing, qualification and continuing education requirements for adviser personnel, the provision of account statements to clients and the financial responsibility of advisers (including requiring fidelity bonds). In the Final Guidance, the SEC notes that it received many comments on these proposals and is continuing to evaluate the comments received with respect to these topics. The SEC states in the Final Guidance that it will address the comments in the future.

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