Investment Management Alert

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SEC Adopts New Interpretation of Fiduciary Duty

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On June 5, 2019, the Securities and Exchange Commission (SEC) adopted a comprehensive interpretation (the "Interpretation")[1] of the fiduciary duties that investment advisers owe to their clients under the Investment Advisers Act of 1940, as amended (the "Advisers Act").[2] The Interpretation is part of a package of new interpretations, forms and rules of conduct for investment advisers and broker-dealers that focus on the relationship between financial professionals and their clients, which were originally proposed in April 2018.[3]

Fiduciary Duty

While several Supreme Court rulings have recognized that the Advisers Act reflects the existence of a federal fiduciary standard for investment advisers,[4] neither the cases that addressed fiduciary duty nor subsequent SEC pronouncements or enforcement actions clearly articulated the practical definition of fiduciary duties.[5] The Interpretation defines investment advisers' fiduciary duties under the Advisers Act to comprise both the duty of care and the duty of loyalty.[6] The Interpretation provides guidance as to the SEC's view of the components of those duties and regarding an investment adviser's ability to vary or modify the fiduciary duty.[7] Unlike in the proposed interpretation, the Interpretation acknowledges that differing applications of the fiduciary duties are appropriate for retail versus institutional clients.

Duty of Loyalty

The duty of loyalty requires that an adviser not subordinate its client interests to its own. The SEC interprets the duty of loyalty to require an investment adviser to eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict.[8]

Full and Fair Disclosure

The SEC believes that an investment adviser must seek to avoid conflicts or at least must make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship in a sufficiently specific manner so that a client is able to decide whether to provide informed consent to the conflicts.[9] In order for disclosure to

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be full and fair, it 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, "it would be inadequate to disclose that the adviser has 'other clients' without describing how the adviser will manage conflicts between clients if and when they arise, or to disclose that the adviser has 'conflicts' without further description."[10] Additionally, the SEC notes that stating that an adviser "may" have a particular conflict when the conflict actually exists, or simply listing all possible or potential conflicts regardless of likelihood, is not adequate. However, the word "may" could be appropriate to disclose a potential conflict that does not currently exist but might reasonably arise in the future. The SEC believes that full and fair disclosure is likely to differ for institutional clients because of their sophistication and familiarity with financial markets,[11] but regardless, the disclosure must be clear and detailed enough for the particular client to make an informed decision.

Informed Consent

A client's informed consent can be explicit or implicit, depending on the facts, but it would run afoul of the duty of loyalty to infer or accept client consent if the adviser knew or reasonably should have known that the client did not understand the nature and import of the conflict. "For retail clients in particular, it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable."[12] In that circumstance, the adviser should either eliminate or adequately mitigate the conflict so that full and fair disclosure and informed consent are possible.

Duty of Care

The Interpretation also states that investment advisers owe a duty of care to their clients, which means an adviser must, at all times, serve the best interest of its client based on the client's objectives. The Interpretation states that the duty of care includes, without limitation, the duties to (i) provide advice that is in the client's best interest, (ii) seek best execution and (iii) act and provide advice and monitoring over the course of the relationship. The adviser's fiduciary duty applies upon account opening and to all investment advice, "including advice about investment strategy, engaging a sub-adviser and account type."[13] The application of the duty of care, however, may vary based on the scope of the client relationship.

Duty to Provide Advice in the Client's Best Interest

The SEC interprets the duty of care to require investment advisers to ensure that the advice is suitable and otherwise in the best interest of the client, based on a reasonable understanding of the client's objectives. The basis for such a reasonable understanding generally would include, for retail clients, an understanding of the investment profile, or for institutional clients, an understanding of the investment mandate.[14] How an adviser develops this reasonable understanding will vary based on the nature and scope of the relationship.

For a retail client, at a minimum, an adviser should make a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience and financial goals. The types of information reviewed for a retail client (especially for financial planning) could include current income, investments, assets and debts, marital status, tax status, insurance policies and financial goals.[15] The SEC believes that it will generally be necessary for an adviser to a retail investor to update the

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client's investment profile in order to consider changes to laws or the client's circumstances.

By contrast, the nature and extent of the reasonable inquiry for institutional clients is shaped by the specific investment mandate from those clients. An adviser to institutional investors does not have an obligation to advise on the entire portfolio; it can assume that its obligation is constrained to the established investment directive. Similarly, an investment adviser whose client is a registered investment company or private fund would need to have a reasonable understanding of the fund's investment guidelines or directives. The obligation to update the client's objectives would not be applicable to institutional investors except as may be set forth in the advisory agreement.

In addition, an investment adviser must have a "reasonable belief" that its advice is in the best interest of the client. This reasonable belief must be based on an evaluation of the portfolio the adviser manages for the client and the client's objectives. For example, some high risk products, such as penny stocks or other thinly traded securities, may be in a retail client's best interest for a short time but would require daily monitoring by the adviser. Factors an adviser should consider in determining whether a security or strategy is in its client's best interest include the cost (including fees and compensation), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit. The fiduciary duty does not require an adviser to recommend the lowest cost investment product or strategy. Indeed, an adviser would expressly not satisfy its duty of care by simply advising its client to invest in the lowest cost product or strategy without any further analysis of other factors in the context of the client's portfolio and objective. Finally, the adviser's reasonable belief must be based on a reasonable, independent investigation into the investment so that the advice is not based on materially inaccurate or incomplete information.

Duty to Seek Best Execution

The SEC interprets the duty of care to require investment advisers to seek to obtain the execution of securities transactions on behalf of a client with the goal of maximizing value (including total cost or proceeds) for the client under the particular circumstances occurring at the time of the transaction. Factors for best execution analysis include the value of research provided, execution capability, commission rate, financial responsibility and responsiveness. The SEC is clear that the "determinative factor" is not the lowest possible commission cost, but whether the transaction represents the best qualitative decision. An adviser should periodically and systematically evaluate best execution.

Duty to Act and to Provide Advice and Monitoring over the Course of the Relationship

The SEC interprets the duty of care to require investment advisers 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 relationship. Investment advisers can limit this obligation, however, through contracts that either limit the length of investment advisory services or expressly state the frequency of monitoring, provided there is full and fair disclosure and informed consent.

Ability to "Disclose Away" or Vary Fiduciary Duties by Contract

Application Based on Scope of Relationship

Importantly, the Interpretation expressly provides that the federal fiduciary duty cannot be altogether waived, but the adviser and its client can shape the relationship by contract, provided that there is full and fair disclosure and informed consent.[16] The SEC makes clear that certain limits apply to the right to vary or disclose away duties. First, the Interpretation emphasizes that any sweeping or broad release of an investment adviser from fiduciary duties, such as by stating that an advisor is not a fiduciary or a blanket waiver of all conflicts, would be inconsistent with the Advisers Act regardless of the sophistication of the client. Additionally, although the Interpretation does not take a position on the scope or substance of any state law fiduciary duties, the SEC stated its view that "there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those antifraud provisions, 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."[17]

Conclusion

The views expressed in the Interpretation expand the scope of judicial interpretations of the fiduciary duties of investment advisers under the Advisers Act set forth in cases like *Capital Gains*[18] or *Transamerica*,[19] which emphasized the duty to disclose an adviser's conflicts of interest. While the expansive interpretation is likely to have its most significant impact in retail relationships, it may also be expected to result in more enforcement actions and examination inquiries involving institutional clients.

1 See "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Advisers Act Release 5248 (the "Interpretation") available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

2 The Interpretation applies to both registered and exempt investment advisers.

3 "Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation," Advisers Act Release 4889 (the "Proposed Interpretation") available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf. The Proposed Interpretation also requested comments as to whether investment advisers should be subject to additional requirements that are currently applicable to broker-dealers, such as licensing and examination, continuing education, account statements and capital or bonding requirements. The Interpretation states that the SEC is continuing to evaluate the comments received in response.

4 See *Transamerica Mtg. Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

5 Interpretation at 7.

6 The duty of full disclosure also forms a part of the fiduciary duties of an investment adviser, due to the requirement of a loyal agent to disclose any potential conflicts of interest that the agent may have.

7 The Interpretation does not address the extent to which the Advisers Act applies to different types of impersonal investment advice.

8 The Interpretation states that the duty of loyalty also applies to mitigating conflicts of interest between clients, even if there is no improper benefit to the adviser. It identifies trade allocation as an example. Perhaps in recognition of the novelty of this asserted duty, the Interpretation states that this obligation does not require investment advisers to allocate all trades pro rata, nor does it prohibit an investment adviser from taking the individual needs of clients into account or using the investment adviser's judgment.

9 The Interpretation, however, states, "[w]hile 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, an adviser is prohibited from overreaching or taking unfair advantage of a client's trust." Interpretation at n. 57.

10 Interpretation at 24.

11 The Interpretation suggests that some conflicts are so complicated that retail clients may not be able to provide informed consent for certain particularly complicated conflicts.

12 Interpretation at 28.

13 Interpretation at 18.

14 The above suitability requirements apply in only the case of personalized advice. Published advice and potentially robo-advisers are not typically held to the same suitability standard.

15 The SEC stated that it is generally reasonable for an adviser to rely on information provided to it by the client or client's agent.

16 The Interpretation acknowledges that the obligations to a retail client for which the adviser forms a principal part of the portfolio are different from those to an institutional client (including a fund) in which the contract defines the scope of the services and provides limitations on the adviser's authority with substantial specificity.

17 Interpretation at 11. Accordingly, because the SEC is expressing its views regarding hedge clauses in the Interpretation, it has simultaneously withdrawn the *Heitman* no-action letter (Feb. 12, 2007).

18 See *Capital Gains*, 375 U.S. 180.

19 See *Transamerica*, 444 U.S. 11.

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