

# Investment Management Alert

May 7, 2018

## SEC Proposes New Interpretation of Fiduciary Duty

On April 18, 2018, the Securities and Exchange Commission (SEC) proposed a new interpretation (the “Proposed Interpretation”)<sup>1</sup> of the fiduciary duties of investment advisers under the Investment Advisers Act of 1940, as amended (the “Advisers Act”). The Proposed Interpretation is part of a package of new interpretations, forms and rules of conduct for investment advisers and broker-dealers who make recommendations to retail clients. The Proposed Interpretation also requests 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.

### Fiduciary Duty

The Proposed Interpretation sets forth the SEC’s views of investment advisers’ fiduciary duties under the Advisers Act, including the duties of care and loyalty,<sup>2</sup> and the SEC’s views on an investment adviser’s ability to vary or modify the fiduciary duty. Such an interpretive proposal of an existing obligation, unlike a rule or form proposal, could have some legal effect from the date of its publication and could be cited in SEC enforcement proceedings.<sup>3</sup>

### Duty of Care

The Proposed Interpretation states that investment advisers have a duty of care to their clients, which includes the duty to protect against nonfeasance, such as neglect. As part of the duty of care, the Proposed Interpretation highlights 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.

### *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 (through inquiry of the financial sophistication and situation, risk tolerance and investment objectives) and

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<sup>1</sup> These obligations apply to all investment advisers, as defined under the Advisers Act, irrespective of their registration status. See “Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation,” Advisers Act Release 4889 available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>.

<sup>2</sup> 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.

<sup>3</sup> The Proposed Interpretation could have such an impact even though it does not cite any judicial decision by the federal courts, nor are we aware of any, in which the ruling on the facts presented supports the Proposed Interpretation.

otherwise in the best interest of the client.<sup>4</sup> The investment adviser must also update its advice if there are changed circumstances, such as events that occur to the investor or changes in law that impact the investment decisions. The investment adviser must also have independently and reasonably investigated the securities before recommending them to clients.

### ***Duty to Seek Best Execution***

The SEC interprets the duty of care to require investment advisers to “seek to obtain the execution of transactions for each of its clients such that the client’s total cost or proceeds in each transaction are most favorable under the circumstances.”<sup>5</sup> The SEC clarified, however, that the determination may also take qualitative factors, such as research capabilities, execution capabilities, financial responsibility and responsiveness, into account in determining the favorable cost, in addition to the commission rate.

### ***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 ongoing supervision of the accounts even if there is no trading in the account. 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.

### ***Duty of Loyalty***

The SEC interprets the duty of loyalty to require an investment adviser not to favor its interests over its clients’ interests and not to favor one client’s interests over another client’s interests. The SEC believes that an investment adviser must seek to avoid conflicts and 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. As part of the obligation to treat clients fairly, investment advisers must allocate trades fairly among their clients. The Proposed 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. Rather, the investment adviser’s allocation policies must be fair, and any conflict of interest must be fully and fairly disclosed.

### **Ability to “Disclose Away” or Vary Fiduciary Duties**

The Proposed Interpretation states, “Although the ability to tailor the terms means that the application of the fiduciary duty will vary with the terms of the relationship, the relationship, in all cases, remains that of a fiduciary to a client. In other words, the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty.”<sup>6</sup>

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<sup>4</sup> 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.

<sup>5</sup> Proposed Interpretation, text after footnote 33.

<sup>6</sup> Proposed Interpretation, text at footnote 21.

The above quotation does not mean that the duty of loyalty requires the elimination of all conflicts of interest to satisfy the duty of loyalty or that the scope of services may not be specifically limited in order to satisfy the duty of care. Instead, the Proposed Interpretation emphasizes that any sweeping or broad release of an investment adviser from fiduciary duties is likely not enforceable, since such a release would provide the adviser with discretion that could be used in unforeseen ways and would not provide sufficient disclosure for the client to adequately consent. It therefore remains the case that an investment adviser with conflicts of interest must make full and fair disclosure of all material conflicts that could adversely affect the advisory relationship in a sufficiently specific manner to permit the client to provide informed consent.<sup>7</sup> The Proposed Interpretation reiterates that disclosure that a person “may” have a conflict is likely insufficient.

The SEC also states that “disclosure of a conflict alone is not always sufficient to satisfy the adviser’s duty of loyalty and section 206 of the Advisers Act.”<sup>8</sup> Some limits apply to the ability to disclose away fiduciary duty. It further states, “It would not be consistent with an adviser’s fiduciary duty to infer or accept consent to a conflict where either (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict or (ii) the material facts concerning the conflict could not be fully and fairly disclosed.”<sup>9</sup> The SEC expects an investment adviser that cannot obtain effective consent because of the above concerns to eliminate the conflict or to be able to mitigate the conflict so that it becomes a conflict that may be disclosed and consented.

### **Potential Additional Requirements**

In addition to the re-interpretation of the fiduciary duties under the Advisers Act, the SEC also asked whether investment advisers should be subject to many of the obligations that currently apply to only broker-dealers. Specifically, the SEC is also considering (i) federal licensing (i.e., testing) and continuing education requirements,<sup>10</sup> (ii) a requirement for investment advisers to directly or indirectly provide account statements to clients contemporaneously with the payment of fees, and (iii) a fidelity bond or

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<sup>7</sup> The SEC approvingly cites to the Restatement (Third) of Agency §8.06, “conduct by an agent does not constitute a breach of duty if the principal consents to the conduct, provided that (a) in obtaining the principal’s consent, the agent (i) acts in good faith, (ii) discloses all material facts that the agent knows, has reason to know or should know that would reasonably affect the principal’s judgment unless the principal has manifested that such facts are already reasonably known by the principal or that the principal does not wish to know them and (iii) otherwise deals fairly with the principal; and (b) the principal’s consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship.”

<sup>8</sup> Proposed Interpretation, text at footnote 44.

<sup>9</sup> Proposed Interpretation, text at footnote 48.

<sup>10</sup> The SEC inquired whether the testing obligations should be imposed on only investment advisers with more than five clients or 10 percent of clients that are natural persons, consistent with exceptions from states’ ability to impose licensing requirements.

other capital requirements.<sup>11</sup> For these considerations to become effective, however, separate proposed rules and adoption would be required.

## Conclusion

Given that the Proposed Interpretation sets forth the SEC's current views on what constitutes the fiduciary duties of investment advisers, it is likely that the SEC will use the definition and may bring enforcement actions based on violation of the standards set forth in the Proposed Interpretation even if the Proposed Interpretation is not finally adopted. The views expressed in the Proposed Interpretation appear to broaden the judicial views of the fiduciary duties under the Advisers Act set forth in cases like *Capital Gains*<sup>12</sup> or *Transamerica*,<sup>13</sup> which emphasized the duties of loyalty and disclosure. Instead, the Proposed Interpretation appears to shift the Advisers Act from a disclosure statute, as is the case in other securities statutes, to one of substantive duties. It is also unclear how the SEC will approach the waiver of fiduciary duties under state law in limited partnership agreements or investment management agreements, and the effect that would have on private rights of action by investors or clients.<sup>14</sup>

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<sup>11</sup> The SEC inquired whether the North American Securities Administrators Association (NASAA) proposals of (i) investment advisers with custody to maintain a net worth of \$35,000, (ii) an investment adviser with discretionary authority to maintain a \$10,000 net worth, and (iii) an investment adviser that accepts prepayment of fees to maintain a positive net worth would make the most sense.

<sup>12</sup> *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

<sup>13</sup> *Transamerica Mtg. Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979).

<sup>14</sup> In *Transamerica*, the Supreme Court ruled that clients of an investment adviser have only a limited private right of action against an investment adviser under the Advisers Act to void an investment adviser's advisory contract.

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