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Client Alert

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SEC Issues Interpretive Release on Investment Adviser Standard of Conduct

In conjunction with the passage of Regulation BI and the adoption of Form CRS, on June 5, 2019, the Securities and Exchange Commission issued a wide-ranging Interpretive Release that "reaffirms" and "clarif[ies]" certain aspects of the fiduciary duty that an investment adviser[1] owes to its clients under Section 206 of the Investment Advisers Act of 1940. This Client Alert focuses on the practical implications of the SEC's views on the scope of an adviser's fiduciary duty to clients. Investment advisers registered with the SEC should take the SEC's views contained in the Interpretive Release into account as they manage their business.

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Overall, the SEC stated that an investment adviser's fiduciary duty is broad, applies to the entire adviser-client relationship and is made enforceable by the anti-fraud provisions of the Advisers Act. The Interpretive Release emphasizes the SEC's specific view that an adviser's fiduciary duty under the Advisers Act is comprised of both the duty of loyalty and the duty of care, which, when combined and in light of the adoption of Regulation BI,[2] can be characterized as requiring an investment adviser "**to act in the best interests of its clients at all times.**"

The SEC further explained that an adviser's fiduciary duty follows the contours of the relationship between the adviser and its client, who may shape their relationship by agreement, provided that there is full and fair disclosure and informed consent.

Finally, the SEC specifically warned the industry that an adviser may not waive its fiduciary duty.[3]

WHAT IS THE DUTY OF CARE?

The SEC stated that the duty of care requires an adviser to provide investment advice in the best interests of its clients based on clients' objectives. The SEC provided specific guidance by which an adviser can exercise care in its relationship with its clients as follows.

An Adviser Must Provide Advice That Is in the Best Interests of the Client

Notably, the SEC stated that an adviser needs to provide advice that is suitable for each client. In order to provide such advice, an adviser must have a reasonable understanding of each client's objectives.

For retail clients, the SEC stated that an adviser should:

- At a minimum, make a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience and financial goals (i.e., understand the "investment profile").
- Update the client's investment profile in order to maintain a reasonable understanding of the client's objectives and adjust the advice to reflect any changed circumstances.[4]

For institutional clients, the SEC explained that the nature and extent of the reasonable inquiry into clients' objectives generally is shaped by the specific investment mandates from those clients.[5]

For pooled vehicles, the SEC explained that the adviser would need to have a reasonable understanding of the fund's investment guidelines and objectives.

An Adviser Must Have a Reasonable Belief That Advice Is in the Best Interests of the Client

The SEC confirmed that the duty of care includes the requirement that the adviser have a reasonable belief that advice is in the best interests of clients, and it provided specific guidance as to how an adviser can form that reasonable belief, noting the following:

- The adviser should evaluate its advice in the context of the portfolio that it is managing for the client and the client's objectives, taking into account the nature of the client (i.e., whether the client is a retail or an institutional client).

- For high-risk products – such as penny stocks or other thinly traded securities – the adviser should generally apply heightened scrutiny to whether such investments fall within a retail client's risk tolerance and objectives. A similar standard applies to complex products – such as leveraged or inverse exchange-traded funds (i.e., those designed primarily as short-term trading tools for sophisticated investors) – to the extent these products were in the best interests of a retail client initially, they would require daily monitoring.

- The adviser should conduct a reasonable investigation into the investment so as not to base its advice on materially inaccurate or incomplete information.

- The adviser should examine the cost (including fees and compensation) associated with investment advice, as well as the product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit.[6]

Finally, the SEC explained that the duty of care applies to all investment advice provided to clients, including advice about investment strategy, engaging a subadviser and account type.[7]

Duty to Seek Best Execution

Consistent with its prior statements, the SEC also specifically stated that an investment adviser's duty of care includes a duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades. In meeting this obligation, the SEC stated that an adviser must 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 the most favorable under the circumstances." In seeking to further define this obligation of care, the SEC stated:

- An adviser should seek to obtain the execution of securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction.

- An adviser should consider "'the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility,

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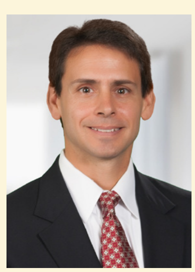

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and responsiveness' to the adviser." In other words, the SEC stated that the "determinative factor" is not the lowest possible commission cost "but whether the transaction represents the best qualitative execution."

- An investment adviser should "periodically and systematically" evaluate the execution of transactions it is handling for clients.

Duty to Provide Advice and Monitoring Over the Course of the Relationship
Finally, the SEC stated for the first time that an investment adviser's duty of care encompasses the duty to provide advice and monitoring at a frequency that is in the best interests of the client, taking into account the scope of the agreed relationship.[8] The SEC stated that as a general matter, an adviser's duty to monitor extends to all personalized advice it provides to the client, including, for example, in an ongoing relationship, an evaluation of whether a client's account or program type continues to be in the client's best interests.

WHAT IS THE DUTY OF LOYALTY?

The second part of the Interpretive Release contained the SEC's views on the duty of loyalty, which the SEC consistently has interpreted to mean that an adviser may not subordinate its clients' interests to its own. The SEC stated that in order to meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, including the capacity in which the firm is acting with respect to the advice provided.[9]

In addition, the SEC stated that 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." Finally, the SEC explained that whether disclosure is full and fair will depend on, among other things, the nature of the client, the scope of the services, and the material fact or conflict.[10]

To illustrate what it views as full and fair disclosure, the SEC provided guidance on the appropriate level of specificity that advisers should attain in their disclosure, and also discussed the considerations that investment advisers should take into account for disclosure regarding conflicts related to the allocation of investment opportunities among eligible clients.

Specificity of Disclosure

- The SEC explained that for disclosure to 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 about whether to provide consent.
- Moreover, the SEC explained that disclosure that an adviser "may" have a particular conflict, without more details, is not adequate if conflict actually exists.
- The SEC elaborated that it would consider the use of "may" in disclosure to be inappropriate when the conflict exists with respect to some (but not all) types or classes of clients, advice, or transactions without additional disclosure specifying the types or classes of clients, advice, or transactions with respect to which the conflict exists.[11]

Trade Allocations

- The SEC reaffirmed its prior position on how an adviser can meet its duty of loyalty with regard to trade allocations by noting that when an advisor allocates investment opportunities among eligible clients, the duty of loyalty requires the adviser to 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 – such that a client can provide informed consent.
- The SEC confirmed that when allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship and need not have pro rata allocation policies or any particular method of allocation.

In responding to commenters who objected to what they saw as subjectivity in the SEC's proposed use of the term "informed" to describe a client's consent to disclosed conflict, the SEC explained that full and fair disclosure does not require advisers 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. Rather, the SEC stated that the disclosure should be designed to put a client in a position to be able to understand and provide informed consent to the conflict of interest.[12]

Finally, in what can only be viewed as a warning to the industry, the SEC stated that some conflicts may be of such a nature and extent that it would be difficult to provide disclosure to clients that "adequately conveys the material facts or the nature, magnitude, and potential effect of the conflict sufficient for a client to consent to or reject it." The SEC further warned that in some instances, disclosure may not be specific enough for a client to understand whether and how the conflict could affect the advice it receives. Specifically, for retail clients in particular, the SEC stated that where there are complex or extensive conflicts, it may be difficult to provide disclosure that is sufficiently specific but also understandable. In summary, the SEC stated that when an investment adviser cannot fully and fairly disclose a conflict of interest to a client such that the client can provide informed consent, 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.

CONSEQUENCES OF THE ADOPTION OF THE INTERPRETIVE RELEASE

Although the industry currently is digesting the suite of regulatory changes that the SEC adopted, given that the Interpretive Release becomes effective immediately, registered investment advisers should promptly consider examining their businesses for compliance with the Interpretive Guidance. Certain of the questions that we believe registered investment advisers need to ask include:

- Does my code of ethics or other foundational governing document lay out that my business should be run to ensure that my business conducts itself as a fiduciary and in the best interests of our clients at all times?
- Do my existing advisory contracts clearly describe the contours of the relationship and the services provided, and does that the contract, along with other disclosure documents, provide for full and fair disclosure and informed consent?
- Do my advisory contracts have "hedge clauses," and if so, are those clauses consistent with the guidance contained in the Interpretive Release?
- Do I have sufficient processes to understand each client's investment profile? And do I update that profile timely to reflect changed circumstances?
- Does my firm have policies and procedures designed to provide me with a reasonable belief that the advice I provide is in my clients' best interests? Do those policies and procedures address high-risk products for my "retail" clients? Do those policies and procedures include guidance on selecting account types and dealing with rollovers, including for prospective clients? Have I addressed each of the above questions if my firm also is registered as a broker-dealer?
- Is how I define "best execution" in my standard advisory contract or Form ADV, Part 2, consistent with the definition contained in the Interpretive Release? Do I have best execution policies and procedures, and do those procedures require me to periodically and systematically evaluate execution on behalf of my clients?
- Have I adopted policies and procedures designed to ensure that I monitor my clients' accounts at an appropriate frequency and consistent with my advisory contracts?
- Do I use the word "may" or similar words appropriately within my disclosure documents?
- Do my trade allocation procedures consider the nature and objectives of each client and the scope of each relationship?

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[1] The SEC specifically noted that the Interpretive Release applies to "robo" or "automated" advisers.

[2] For an overview of the impact of Regulation BI and Form CRS, please see SEC Adopts Regulation Best Interest, Form CRS, and Advisers Act Interpretations, Risk&Reward, June 6, 2019 (https://www.stradley.com/insights/publications/2019/06/risk-and-reward-june-6-2019).

[3] The SEC specifically stated that a contract containing (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest or (iii) a waiver of any specific obligation under the Advisers Act would be inconsistent with the Advisers Act, regardless of the sophistication of the client.

Moreover, in an interesting note, the SEC withdrew the Heitman Capital Management LLC SEC Staff No-Action Letter (Feb. 12, 2007) with regard to an adviser's ability to use a "hedge clause" within an advisory contract (i.e., where the contract seeks to relieve the adviser from liability for conduct as to which the client has a nonwaivable cause of action against the adviser provided by state or federal law). Rather, the SEC stated that whether a hedge clause violates the Advisers

Act's anti-fraud provisions depends on all the surrounding facts and circumstances, including the particular circumstances of the client (e.g., sophistication). However, the SEC warned that there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with those anti-fraud provisions. The SEC further noted that whether a hedge clause in an agreement with an institutional client would violate the Advisers Act's anti-fraud provisions will be determined based on the particular facts and circumstances.

[4] According to the SEC, the frequency with which an adviser must update a client's investment profile should be based on facts and circumstances, including whether the adviser is aware of events that have occurred that could render inaccurate or incomplete the investment profile on which the adviser currently bases its advice.

[5] Interestingly, the SEC did not define what it views to be a "retail" versus an "institutional" client. While reference can certainly be drawn to definitions contained in Regulation BI and elsewhere throughout the federal securities laws, this lack of definition might have been deliberate so as to allow each adviser to assess how to classify its client base based on its own facts and circumstances.

[6] According to the SEC, when an adviser considers similar investment products or strategies, the adviser would not satisfy its fiduciary duty by simply advising the client to invest in the lowest-cost investment product or strategy without further analysis of other factors. In that regard, the SEC stated that an adviser can recommend a higher-cost investment or strategy if the adviser reasonably concludes that there are other factors about the investment or strategy that outweigh cost and make the investment or strategy one that is in the best interests of the client, in light of that client's objectives.

[7] The SEC stated that advice about account type includes advice about whether to open or invest through a certain type of account (e.g., a commission-based brokerage account or a fee-based advisory account) and advice about whether to roll over assets from one account (e.g., a retirement account) into a new or existing account that the adviser or an affiliate of the adviser manages. The SEC also specifically stated that an adviser should consider all types of accounts offered by the adviser and acknowledge to a client when the account types the adviser offers are not in the client's best interests. The SEC also noted that investment advisers have a fiduciary duty to "prospective" clients under the anti-fraud provisions of the Advisers Act – our view about these SEC pronouncements is that the SEC was indicating that an investment adviser cannot make materially misleading statements or omissions to prospective clients to induce them to become a client, and investment advisers must be able to provide appropriate advice to the client before the relationship formally starts.

[8] The SEC indicated that an adviser and client may agree to the "scope" of the frequency of such monitoring, provided that there is full and fair disclosure and informed consent. In an important note, the SEC emphasized that the frequency of monitoring, as well as any other material facts relating to the agreed frequency, will be "a material fact relating to the advisory relationship about which an adviser must make full and fair disclosure and obtain informed consent."

[9] The SEC noted the importance of disclosure for dual registrants, stating that disclosure may be accomplished through a variety of means, including, among others, written disclosure at the beginning of a relationship that clearly sets forth when a dual registrant would act in an advisory capacity and how it would provide notification of any changes in capacity.

[10] The SEC helpfully noted that full and fair disclosure for an institutional client (including the specificity, level of detail and explanation of terminology) can differ from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than do retail clients to analyze and understand complex conflicts and their ramifications.

[11] The SEC further explained that the use of "may" in disclosure would be inappropriate if it simply precedes a list of all possible or potential conflicts regardless of likelihood and obfuscates actual conflicts to the point that a client cannot provide informed consent. On the other hand, the SEC noted that the word "may" could be appropriately used to disclose to a client a potential conflict that does not currently exist but might reasonably present itself in the future.

[12] The SEC explained that a client's informed consent can be either explicit or, depending on the facts and circumstances, implicit. Importantly, the SEC indicated that such consent need not be in writing – for example, the SEC stated that an adviser could provide appropriate disclosure through a combination of Form ADV and other disclosure and the client could implicitly consent by entering into or continuing the advisory relationship. Finally, the SEC noted that it would not be consistent with an adviser's fiduciary duty to infer or accept client consent where the adviser was aware, or reasonably should have been aware, that the client did not understand the nature and import of the conflict.

