Schulte Roth&Zabel

Private Funds Regulatory

UPDATE

SEC Releases Final Interpretation of the Standard of Conduct for Investment Advisers

August 2019

The U.S. Securities and Exchange Commission has, for some time, been reviewing the standard of conduct required of investment advisers and broker-dealers under the federal securities laws. On June 5, 2019, these various initiatives concluded with the publication of four final items of guidance:

- *Commission Interpretation Regarding the Standard of Conduct for Investment Advisers* ("Fiduciary Interpretation");
- *Form CRS Relationship Summary; Amendments to Form ADV* ("Form CRS Release");
- *Regulation Best Interest*; and
- *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser* ("Solely Incidental Interpretation")

Fiduciary Interpretation

The Fiduciary Interpretation is the most important of the four items for private fund advisers. In the proposing release, the SEC indicated that it was considering certain positions that would treat advisory clients and investors the same, regardless of their sophistication. For example, the SEC proposal stated 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," and consent would not be effective where "the material facts concerning the conflict could not be fully and fairly disclosed."

The final Fiduciary Interpretation, however, hewed more closely to existing interpretations of fiduciary obligations under the Advisers Act.

1. *Federal Fiduciary Duty*. The SEC's view, citing U.S. Supreme Court decisions (and its own precedent), is that the Investment Advisers Act unambiguously establishes a federal fiduciary duty for investment advisers. Part of the goal of the Fiduciary Interpretation was to emphasize the SEC's position that this fiduciary duty exists, that it exists for all categories of clients and that it cannot be categorically waived.
2. *Conflicts of Interest Waivers*. The Fiduciary Interpretation did acknowledge and respond to industry concerns that the SEC would adopt the views from the proposal (i) that there are "circumstances in which disclosure alone cannot cure a conflict of interest" and (ii) that "an adviser must seek to

avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest."

With respect to the efficacy of disclosure in curing conflicts of interest, the SEC clarified in the Final Interpretation that "[w]e believe that while full and fair disclosure of all material facts relating to the advisory relationship or of conflicts of interest and a client's informed consent prevent the presence of those material facts or conflicts themselves from violating the adviser's fiduciary duty, such disclosure and consent do not themselves satisfy the adviser's duty to act in the client's best interest."

In addition, rather than adopting the proposal's language that would require advisers to "seek to avoid" and "disclose" conflicts of interest, the Fiduciary Interpretation set forth a position requiring an 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."

The importance of this sentence should not be overlooked. In the Fiduciary Interpretation, the SEC has (i) acknowledged that advisers are not required to "seek to avoid" all conflicts of interests; rather, an adviser may utilize disclosure in lieu of eliminating a conflict; and (ii) validated an "informed consent" concept for conflict of interest disclosures by an adviser.

3. *Contractual Limits*. The Fiduciary Interpretation expressly acknowledged that retail and institutional investors are differently positioned in their ability to assess conflicts, stating that "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[1] However, the SEC made clear that this "greater capacity and more resources" point only goes so far, noting that "while the application of the investment adviser's fiduciary duty will vary with the scope of the relationship, the relationship in all cases remains that of a fiduciary to the client." The Fiduciary Interpretation specifically noted that overbroad waivers, such as the following, will not be permitted:
    - A contractual provision purporting to waive the adviser's federal fiduciary duty generally;
    - A statement that the adviser will not act as a fiduciary;
    - A blanket waiver of all conflicts of interest; or
    - A waiver of a specific obligation under the Investment Advisers Act.
4. *Guidance on the Duty of Care.* In the Fiduciary Interpretation, the SEC stated that an advisers fiduciary duties encompass a duty of care as well as a duty of loyalty. The Fiduciary Interpretation contains a number of indications as to what the "duty of care" is under the Investment Advisers Act. As set forth in the Fiduciary Interpretation, these obligations run to suitability (and a duty of inquiry to support a reasonable belief that advice is in the best interests of a given client), an

[1] *Commission Interpretation Regarding the Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248, at 25-26 (June 5, 2019).

obligation to seek best execution and a requirement to monitor performance over the course of a relationship.

5. *Use of Contingent Language in Disclosures.* The Fiduciary Interpretation specifically addressed the use of contingent disclosures, stressing that an adviser may not state that it "may" have a conflict when (i) the adviser, in fact, generally has the conflict or (ii) has such a conflict with respect to some, but not all, of the adviser's clients. Importantly, the SEC clarified that the use of "may" in disclosures of potential conflicts is appropriate when a conflict does not currently exist, but might reasonably present itself in the future.
6. *Specific Guidance on Allocation Policies.* The SEC specifically addressed investment allocation policies, which have been a keen focus in many examinations. In response to concerns from commenters that the SEC proposal could be viewed as requiring advisers to adopt rigid pro rata allocation policies, language in the Fiduciary Interpretation stressed that "when allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship. An adviser need not have pro rata allocation policies, or any particular method of allocation, but, as with other conflicts and material facts, the adviser's allocation practices must not prevent it from providing advice that is in the best interest of its clients."

The Fiduciary Duty Interpretation is the SEC's first holistic statement regarding an investment adviser's federal fiduciary duties. It provides clarifications and precedent that we expect will be relied upon by both investment advisers and the SEC going forward. It also highlights the fact that the actual effectiveness of any given disclosure will remain to be determined in a "facts and circumstances" review.

Form CRS Release

The Form CRS Release requires registered investment advisers that provide advisory services to "retail investor" clients to complete, file and deliver new Part 3 of Form ADV, also known as a Form CRS Relationship Summary. The Form CRS Release confirmed that "[i]f a firm does not have retail investor clients … and is not required to deliver a relationship summary to any clients … , the firm will not be required to prepare or file a relationship summary." As the D.C. Circuit held in *Goldstein v. SEC*,[2] in the private fund context, the private fund itself is an adviser's client and, absent a separate relationship, investors in such private fund are not advisory clients.

For those advisers with separately managed accounts, it is important to note that "retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks or receives services primarily for personal, family or household purposes," which the SEC interprets broadly as any services provided to a natural person for his or her own account.[3] In other words, wealthy and

[2] 451 F.3d 873 (D.C. Cir. 2006).

[3] 17 CFR 275.204-5(d)(2).

sophisticated individuals are still "retail investors" who must receive the new mandated disclosure in Form CRS.

Firms that are required to complete Part 3 of Form ADV must file their initial relationship summary with the SEC between May 1, 2020 and June 30, 2020.

Regulation Best Interest and the "Solely Incidental" Interpretation

Regulation Best Interest and the Solely Incidental Interpretation apply only to broker-dealers and not to investment advisers.

Regulation Best Interest establishes a heightened standard of conduct for broker-dealers and their associated persons. Specifically, the heightened standard of conduct requires broker-dealers to (i) act in the best interest of retail customers when recommending a securities transaction or an investment program involving securities and (ii) establish policies and procedures reasonably designed to identify and disclose conflicts of interest and, when necessary, mitigate or, in certain circumstances, eliminate such conflicts.

The Solely Incidental Interpretation provides that investment advice is "solely incidental" to broker-dealer activity (and therefore a broker-dealer is not classified as an investment adviser under the Advisers Act) when it "is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[4] The Solely Incidental Interpretation reinforces that giving advice as to the value and characteristics of securities should not be the primary business of a firm relying on the broker-dealer exclusion from the definition of investment adviser under the Advisers Act, and it also provided guidance regarding the application of the "solely incidental" prong in the context of:

- Exercising investment discretion over customer accounts, stating that "there are situations where a broker-dealer may exercise temporary or limited discretion in a way that is not indicative of a relationship that is primarily advisory in nature," but "unlimited discretion would not be solely incidental to the business of a broker-dealer;" and
- Account monitoring, providing that the SEC "disagree[s] with commenters who suggested that *any* monitoring of customer accounts would not be consistent with the solely incidental prong."

This article appeared in the August 2019 edition of SRZ's Private Funds Regulatory Update. To read the full Update, ***click here****.*

[4] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, Investment Advisers Act Release No. 5249, at 12 (June 5, 2019).

Contacts:

Brian T. Daly
Partner
Regulatory & Compliance
+1 212.756.2758
brian.daly@srz.com

Marc E. Elovitz
Partner
Regulatory & Compliance
+1 212.756.2553
marc.elovitz@srz.com

Anna Maleva-Otto
Partner
Regulatory & Compliance
+44 (0) 20 7081 8037
anna.maleva-otto@srz.com

Brad L. Caswell
Special Counsel
Regulatory & Compliance
+1 212.756.2072
brad.caswell@srz.com