CLIENT ALERT

SEC Issues Important Guidance on the Advisers Act

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On June 5, 2019, in conjunction with its adoption of the new Regulation Best Interest ("Reg. BI"),[1] the Securities and Exchange Commission published interpretative guidance regarding the standard of conduct that applies to investment advisers (the "Standard of Conduct Interpretation") under the Investment Advisers Act of 1940 (the "Advisers Act")[2] and the scope of the broker-dealer exclusion from the definition of "investment adviser" in Section 202(a)(11)(C) of the Advisers Act (the "Solely Incidental Interpretation").[3] As noted by Chairman Clayton, the issuance of this new guidance is part of a "rulemaking package" designed to bring "legal requirements and mandated disclosures for broker-dealers and investment advisers in line with reasonable investor expectations, while simultaneously preserving retail investors' access

[1] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031 (June 5, 2019) ("Reg. BI Adopting Release"). For more information regarding Regulation BI, please click here to read the Willkie Farr & Gallagher LLP Client Alert. *See also* Willkie Farr & Gallagher LLP Client Alert regarding the related adoption of Form CRS by clicking here.

[2] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Investment Advisers Act Release No. 5248 (June 5, 2019) ("Standard of Conduct Interpretative Release" or the "Release").

[3] *See* Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser; Investment Advisers Act Release No. 5249 (June 5, 2019) ("Solely Incidental Exclusion Interpretative Release").

to a range of products and services at a reasonable cost."[4] The new guidance is set to become effective upon publication in the Federal Register.[5]

Standard of Conduct Interpretive Release

Federal Fiduciary Standard

The Standard of Conduct Interpretive Release states that the Advisers Act establishes a "federal fiduciary duty" for state- and SEC-registered investment advisers (as well as for advisers that are exempt from registration or prohibited from registering with the SEC),[6] notwithstanding that the Advisers Act does not expressly reference such a standard. The Release notes that, although neither the Advisers Act nor the SEC's rules define the federal fiduciary duty to which an investment adviser is subject, this federal fiduciary duty reflects a "Congressional recognition" of the "delicate fiduciary nature" of the investment advisory relationship and a "Congressional intent" to address conflicts of interest. The Release contrasts the federal fiduciary standard owed by investment advisers to all clients (whether or not the clients are retail) to the "best interest" standard of conduct that a broker-dealer owes to retail customers (but not institutional customers) when recommending securities, securities-related strategies and securities-related accounts.[7] The Release does not directly address the extent to which the Advisers Act applies to different types of "impersonal advice" (although the Fiduciary Interpretation suggests that the fiduciary standard may, in fact, apply to such types of advice).[8]

Contractual Limitations on Advisory Responsibilities

The Standard of Conduct Interpretive Release indicates that the elements of the federal fiduciary duty have been defined using a principles-based approach to provide flexibility to investment advisers to meet the standard in the context of the

4 "SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationship with Financial Professionals," SEC Press Release (June 5, 2019).

5 On June 26, 2019, the U.S. House of Representatives passed an amendment to a financial services and appropriations bill (H.R. 3351) that would prevent the SEC from using funds to implement, administer, enforce or publicize the Standard of Conduct Interpretation and the Solely Incidental Interpretation. As of the date of this Client Alert, the bill has yet to be considered by the Senate.

6 Standard of Conduct Interpretative Release at n.3.

7 Although the Reg. BI Adopting Release did not define the term "best interest," that release indicated that the standard is not a fiduciary standard. It is not clear in the Standard of Conduct Interpretation, however, how the Reg. BI "best interest" standard and the related disclosure and conflict mitigation requirements differ from those outlined in the Standard of Conduct Interpretation for investment advisers.

8 The Release cites as one example of "impersonal investment advice" the definition in Rule 203A-3 under the Advisers Act, which, in the context of defining "investment adviser representative," defines "impersonal investment advice" as "investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts." *See* Standard of Conduct Interpretative Release at note 7.

specific services that they offer. The Release contemplates that investment advisers may define the scope of their duties to an advisory client through contract. The Release notes, however, that, because the federal fiduciary duty is embedded in the anti-fraud provisions of the Advisers Act, an adviser may not waive application of the fiduciary duty. The Standard of Conduct Interpretation provides the following as examples of provisions that would be prohibited in an investment management agreement: (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.[9] The question of whether a clause that limits or clarifies (rather than waives) the liability of an investment adviser under an investment management agreement (*i.e.*, a "hedge clause") would be enforceable depends upon the applicable facts and circumstances, including the sophistication of the client.

The Release expressly states, however, that a hedge clause in an agreement with a retail client would rarely (if ever) be consistent with the anti-fraud provisions of the Advisers Act because it would likely "mislead those retail clients into not exercising their legal rights, in violation of the anti-fraud provisions," even if the agreement otherwise expressly specified that the client continued to retain non-waivable rights.[10] Given that the interpretative guidance is grounded on the anti-fraud provisions of the Advisers Act, it is reasonable to assume that the SEC will apply the guidance to existing investment advisory contracts as well as to future contracts.[11]

Federal Fiduciary Duty Standards

The Release describes the fiduciary duty of investment advisers as comprising the duty of care and the duty of loyalty. These duties – which are described in more detail below – apply to all investment advice provided to clients, including advice regarding investment strategy, engaging a sub-adviser and selecting an account type.[12]

Duty of Care – Best Interest, Due Inquiry, and Suitability

"Best interest" in the context of fiduciary duty is described in the Standard of Conduct Interpretive Release as including a "duty to provide advice that is suitable for the client." Compliance with this duty in the context of *retail clients* requires an investment adviser to make a "reasonable inquiry" into the retail client's investment profile and in the context of

9 *Id.* at pp. 10-11.

10 *See id.* at n.31. In expressing this position, the SEC rescinded a frequently cited 2007 no-action letter, Heitman Capital Management, LLC, SEC No-Action Letter (Feb. 12, 2007).

11 The Release notes that "[b]ecause an adviser's federal fiduciary obligations are enforceable through section 206 of the Advisers Act, we would view a waiver of enforcement of section 206 as implicating section 215(a) of the Advisers Act, which provides that 'any condition, stipulation or provision binding any person to waive compliance with any provision of this title . . . shall be void.'" Standard of Conduct Interpretive Release at n.29.

12 Standard of Conduct Interpretative Release at 18.

institutional clients requires an adviser to ascertain the client's objectives in the context of the adviser's investment mandate.[13] Once a relationship with a retail client has been established, an adviser must update the client's investment profile to reflect changes in the relevant facts and circumstances. By contrast, advisers "acting on specific investment mandates for institutional clients" do not have a duty to update the client's objectives, absent a contractual agreement that provides otherwise.

The responsibilities imposed on investment advisers include "suitability" and a duty to make a reasonable inquiry into a client's investment profile. The language is similar to that applied by the rules of the Financial Industry Regulatory Authority ("FINRA") to broker-dealers when making recommendations.[14] Unlike the description of the suitability and due inquiry requirements applicable to investment advisers included in the Release, the FINRA rules provide an exemption to customer-specific suitability requirements for specified types of institutional and high net worth investors referred to as "institutional accounts." Under the Standard of Conduct Interpretation, however, investment advisers have a suitability and due inquiry obligation with respect to both retail and institutional advisory clients, although the obligations differ based on the client type.

The articulation of an express duty of suitability culminates an effort dating back to at least 1994 to impose a suitability obligation on advisers.[15] Although the 1994 suitability rule was never adopted, a number of SEC enforcement cases have been premised on a lack of client suitability and, as a result, the suitability standard has become incorporated into regulatory standards applicable to investment advisers. The Standard of Conduct Interpretation seeks to formalize adoption of the suitability standard by expressly making the standard an element of an investment adviser's duty of care. As part of compliance with its duty of care, each investment adviser (whether advising retail clients or institutional clients) must also have "a reasonable belief that the advice it provides is in the *best interest* of the client based on the client's objectives." The term "best interest" requires an investment adviser to conduct a reasonable investigation into each proposed investment and customize its investment advice to each client.[16] The investigation should focus on cost (including fees and compensation to the investment adviser), as well as on other "important factors" such as investment

13 Standard of Conduct Interpretative Release at n.35.

14 FINRA Rule 2111 provides "A member or an associated person must have a *reasonable basis* to believe that a recommended transaction or investment strategy involving a security or securities is *suitable* for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."

15 *See* Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients; Investment Advisers Act Release No. 1406 (Mar. 22, 1994).

16 For example, the Release includes as an example that an investment adviser, when advising a retail client that has a conservative investment objective, could find that it is in the client's "best interest" to use a risky instrument, such as a derivative, if the use were to hedge risks in the portfolio. Standard of Conduct Interpretative Release at 15.

objectives, characteristics, liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon and cost of exit. In that context, the Release notes that "heightened scrutiny" would be required of riskier products and complex products, such as inverse or leveraged exchange-traded products, when recommended or purchased by an investment adviser for retail clients. The Release also notes that an adviser is not required to recommend the lowest-cost (to the client) or least-remunerative (to the investment adviser) investment product or strategy. The reasonable investigation required by investment advisers is similar to that required by broker-dealers today under FINRA Rule 2111 when recommending a security, but appears to require a more rigorous evaluation by the investment adviser of the fees underlying a product and the financial incentives to the adviser as opposed to the risks and rewards of the product itself.

Duty of Care – Best Execution

The second obligation underlying an investment adviser's duty of care is the duty to seek best execution of trades for clients when the adviser is responsible for selecting broker-dealers to execute the trades. In that regard, the Release notes that an adviser must 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, and responsiveness."[17] In addition, an investment adviser is obligated to "periodically and systematically" evaluate the execution services it receives for its clients to ensure continued best execution. This guidance is consistent with previous SEC staff guidance regarding the duty of best execution and the SEC's guidance on Section 28(e) of the Securities Exchange Act of 1934, which make clear that the "determinative factor" when seeking to comply with the duty is not the lowest possible cost but rather "whether the transaction represents the best qualitative execution."[18]

Duty of Care – Monitoring

The Release indicates that an investment adviser has a duty to monitor an account that it is advising for a client in a manner that is consistent with the nature of the advisory relationship. The Release notes, for example, that an investment adviser likely would not be required to monitor a client's one-time financial plan provided to the client for a one-time fee. The scope of an adviser's monitoring may be limited (*e.g.*, monitoring only on a quarterly basis), provided that there is full and fair disclosure and informed consent by the client of the arrangement.[19] An investment adviser and its client may agree contractually on the frequency of monitoring and may agree to require monitoring in situations where a duty to

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17 *Id*. at 19.

18 *Id.*

19 *Id.* at n.50.

monitor would not otherwise exist.[20] The Release notes that monitoring also applies to the selection of account types (*e.g.*, a wrap account) and whether the account type continues to be in the best interests of a client.

Duty of Loyalty

Consistent with common law, the Release states that an adviser must not "subordinate its clients' interests to its own" and must make "full and fair disclosure to its clients of all material facts relating to the advisory relationship."[21] The Release clarifies that, at a minimum, investment advisers that are dual registrants must make clear to all clients when they are acting as an adviser and when they are acting as a broker-dealer. The Release also underscores the importance of specificity regarding disclosure of conflicts and points out that simply stating that an adviser "may" have a conflict would not be adequate where a conflict actually exists. Disclosure must be "clear and detailed enough for the client to make an informed decision to consent to the conflict of interest or reject it" even when consent is not sought.[22] Informed consent can be provided by a client implicitly (such as by entering into an investment advisory relationship after the adviser discloses conflicts) as well as explicitly, depending on the circumstances. In discussing the disclosure obligation, the Release cites to General Instruction 3 to Part 2 of Form ADV. The Release indicates that an investment adviser can comply with its disclosure requirements to institutional investors solely through disclosure in the Form ADV but reminds advisers to retail clients that they are required to deliver a relationship summary to these clients in addition to the Form ADV.[23] The Release notes, however, that an adviser's fiduciary duty does not require that full and fair disclosure or informed consent be achieved in a written advisory contract or otherwise in writing. For example, an adviser can provide a client full and fair disclosure of all material facts relating to the advisory relationship, and of all conflicts of interest, through a combination of Form ADV and other disclosures, and the client can implicitly consent by entering into or continuing the investment advisory relationship with the adviser.[24]

The Release also states that investment advisers are required to mitigate, or at least expose through full and fair disclosure, *all* conflicts of interest that "might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested."[25] The Release suggests that disclosure and consent alone will not always satisfy the

[20] *Id.* at p. 20 recognizing that an adviser may not have a duty to monitor in cases where there is a limited engagement, absent an express agreement to the contrary.

[21] *Id*. at 21-22. *See, e.g., Birnbaum* vs. *Birnbaum*, 73 N.Y. 2d 461 (1981) at 466 ("[I]t is elemental that a fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect . . . departure from [the fiduciary's] basic obligations to [those to whom he owes a duty] cannot be countenanced . . . in the absence of both full disclosure and . . . assent.").

[22] *Id.* at 26.

[23] *See* Willkie Client Alert Regarding Form CRS here.

[24] Standard of Conduct Interpretative Release at n.68.

[25] *Id.* at 23.

adviser's duty to act in the client's best interests. In that regard, in situations where the conflicts are too complex to allow for informed client consent through disclosure, the adviser can either eliminate the conflict or adequately mitigate it (*i.e.*, modify practices to reduce the conflict). In the case of retail clients in particular, the Release notes that it may be difficult to provide the level of disclosure required in respect to complex or extensive conflicts.

In addition to conflicts with its own interests, an investment adviser must address and eliminate or disclose conflicts among clients. An adviser must, for example, provide full and fair disclosure regarding its allocation policies such that a client may provide informed consent. The Release notes that an investment adviser is not required to have a *pro rata* allocation policy or any other particular method of allocation and may agree with clients not to make certain opportunities available to them.[26]

Solely Incidental Interpretive Release

The Solely Incidental Interpretative Release provides guidance on the application of the broker-dealer exclusion under Section 202(a)(11)(C) of the Advisers Act. That provision excludes from the obligation to register as an investment adviser any broker or dealer that provides advisory services that are "solely incidental" to the conduct of business as a broker or dealer and without receipt of "special compensation." The Release indicates that the guidance is necessary to address changes that have occurred in the brokerage industry since the exclusion was adopted, as well as applicable court decisions, such as the decision invalidating the SEC's rule regarding fee-based brokerage accounts and a later case alleging that a broker had violated the Advisers Act by failing to disclose incentives to sell proprietary products.

Advice Must Be Reasonably Related to the Business of Effecting Securities Transactions

The Solely Incidental Interpretative Release indicates that the exclusion applies if and when investment advice provided by a broker-dealer is "provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[27] As a result, for the exclusion to apply, the broker-dealer's "primary business" must be providing execution services and not providing investment advice. Similarly, the Release suggests that in order for the exclusion to apply, the particular advice must relate to "effecting securities transactions."

The analysis as to whether advisory services provided by a broker-dealer satisfy the solely incidental prong of the exclusion is based on the facts and circumstances surrounding the broker-dealer's business, the specific services offered,

[26] "An adviser need not have *pro rata* allocation policies, or any particular method of allocation, but, as with other conflicts, the adviser's allocation practices must not prevent it from providing advice that is in the best interest of its clients." Release at 26-27.

[27] Solely Incidental Exclusion Interpretative Release at 12.

and the relationship between the broker-dealer and the customer. The Release specifically notes that the frequency and importance of the advice would not be determinative.[28]

Investment Discretion

Consistent with prior guidance, the Release states that a broker-dealer that can exercise unlimited investment discretion over a customer's account is not eligible for the exclusion, even if the broker-dealer's compensation is transaction-based and not fee-based.[29] The Release distinguishes "unlimited" investment discretion, which it defines as "the ability or authority to buy and sell securities on behalf of a customer without consulting the customer," from "temporary or limited" discretion and notes that "temporary or limited discretion" does not disqualify a broker-dealer from reliance on the exclusion. Temporary or limited discretion includes discretion with respect to: (i) the price and time at which to execute an order for the purchase or sale of a specified quantity of a specific security; (ii) the purchase or sale of a security on an isolated or infrequent basis when a customer is unavailable for a limited period of time;[30] (iii) the exchange of a position in a money market fund for another money market fund or a cash equivalent instrument; (iv) the purchase or sale of securities to satisfy margin requirements or other customer obligations that the customer has specified; (v) the sale of bonds or other securities and purchase of similar bonds or other securities for purposes of realizing a tax loss on the original position; (vi) the purchase of a bond with a specified credit rating and maturity; and (vii) the purchase or sale of a security or type of security limited by specific parameters established by the customer. The Release notes that these examples of temporary or limited discretion are generally related to a broker-dealer's business of effecting securities transactions.

Monitoring

The Release also discusses the extent to which monitoring of a customer's account may fall within the exclusion and notes that an agreement by a broker-dealer to provide monitoring services to a brokerage customer does not preclude the broker-dealer from qualifying for the exclusion or make the broker-dealer an investment adviser *per se*. Continuous account monitoring is not reasonably related to the broker-dealer's primary business when done voluntarily by the broker-

28 *See id.* at 13: "The quantum or importance of investment advice that a broker-dealer provides to a client is not determinative as to whether or not the provision of advice is consistent with the solely incidental prong. Advice need not be trivial, inconsequential, or infrequent to be consistent with the solely incidental prong."

29 *See* Certain Broker-Dealers Deemed Not To Be Investment Advisers; Investment Advisers Act Release No. 2376 (Apr. 12, 2005). This rule was overturned in 2007 by the U.S. District Court of Appeals for the District of Columbia. *See* Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

30 The Release notes that a period extending for a few months may cause the activity to fall outside the exclusion because it could be indicative of a business or customer relationship that is primarily advisory in nature. Solely Incidental Exclusion Interpretative Release at 18.

dealer and absent an agreement with the customer. The Release includes a recommendation that broker-dealers consider adopting policies and procedures that are designed to ensure that any agreed-upon monitoring activities are performed in connection with and are reasonably related to the broker-dealer's primary activities.[31]

Next Steps

The Standard of Conduct and Solely Incidental Interpretations have important implications for both investment advisers and broker-dealers in respect to retail and institutional clients. Please reach out to your relationship lawyers at Willkie Farr & Gallagher to assist you in applying these principles to your business.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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[31] In particular, policies and procedures for both investment advisers and broker-dealers will need to address monitoring of client accounts and client investment activities generally. Both Reg. BI and Form CRS require disclosure around the level of monitoring offered by a broker-dealer or investment adviser and their financial professionals. For more information, please see Willkie's Client Alert from Reg. BI and Form CRS.