

Fiduciary Duties: The SEC Weighs in Again

June 18, 2019

On June 5, 2019, the Securities and Exchange Commission (the “SEC”) voted to adopt a package of rules and interpretations (the “Releases”) designed to “elevate, enhance and clarify” the duties that investment advisers and broker-dealers owe to their customers/clients when providing investment advice and services, particularly to retail customers/clients.¹ The Releases attempt to tackle key issues arising from investor confusion concerning the legal standards that apply to broker-dealers and investment advisers as well as to “help retail investors better understand and compare the services offered and make informed choices of the relationship best suited to their needs and circumstances.”

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Of particular interest to investment advisers, including private fund managers, one of the Releases “reaffirms—and in some cases clarifies—certain aspects of the fiduciary duty” that an investment adviser owes to its clients under Section 206 of the Investment Advisers Act of 1940 (the “Advisers Act”) (the “Final Interpretation”).² The Final Interpretation includes several notable changes and clarifications made in response to comments to the interpretation that the SEC initially proposed (the “Proposed Interpretation”).³ This issue of Debevoise in Depth focuses on the Final Interpretation—in particular, the changes that the SEC made in response to industry comments.⁴

¹ Chairman Jay Clayton, Securities and Exchange Commission, *Statement at the Open Meeting on Commission Actions to Enhance and Clarify the Obligations Financial Professionals Owe to Our Main Street Investors* (June 5, 2019), available [here](#). See also, Press Release, Securities and Exchange Commission, *SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals* (June 5, 2019), available [here](#).

² Securities and Exchange Commission, *Commission Interpretation Regarding Standard of Conduct of Investment Advisers*, Release No. IA-5248 (June 5, 2019), available [here](#).

³ Securities and Exchange Commission, *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Commission on Enhancing Investment Adviser Regulation*, Release No. IA-4889 (Apr. 18, 2018), available [here](#). For more information concerning these previous proposals, please refer to our Client Update, available [here](#).

⁴ We have prepared a separate Debevoise in Depth that describes the other Releases, including Regulation Best Interest and the implementation of Form CRS, a “client relationship summary” that broker-dealers and investment advisers will be required to provide to retail clients/customers. It also summarizes an additional

Highlights

The Final Interpretation makes several important clarifications that are particularly useful for investment advisers with institutional clients (including private fund sponsors):

- In several instances, the Final Interpretation emphasizes the differences between retail clients and institutional clients, including, for example, with respect to (i) the scope of the adviser's obligations to the client (such as the adviser's duty to understand a client's risk tolerance with respect to high-risk investments), (ii) the disclosure of conflicts (and, in particular, complex conflicts), and (iii) the use of hedge clauses. Overall, the Final Interpretation recognizes that institutional clients "generally have greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications," and that their objectives are commonly "shaped by [their] specific investment mandates."
- The Final Interpretation provides guidance on disclosures regarding conflicts, including that the disclosures should (i) not only disclose the conflict but also describe how the adviser will manage the conflict and (ii) avoid the use of "may" where a conflict actually exists.
- The Final Interpretation clarifies two areas of confusion arising from the Proposed Interpretation regarding (i) whether some conflicts are too complex to be addressed with full and fair disclosure and (ii) whether the adviser is required to make an individualized, affirmative determination that a client understands the conflict in order for the client to provide informed consent. Overall, the Final Interpretation recognizes that disclosures should be "clear and detailed enough for the client to make an informed decision to consent" and notes that whether a client has provided informed consent will depend on the facts and circumstances, including the sophistication of the client.
- The Final Interpretation also reaffirms that an adviser need not allocate investment opportunities among clients on a *pro rata* basis so long as it provides full and fair disclosure to clients so they may provide informed consent, but notes that an adviser's allocation policies must not prevent it from acting in the best interest of its clients.

Background

The Final Interpretation states that the fiduciary duty imposed by the Advisers Act requires an adviser “to adopt the principal’s goals, objectives, or ends” and that an “adviser must, at all times, serve the best interest of its client and not subordinate its client’s interest to its own.” In the SEC’s view, “an investment adviser’s obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty.” The duty of care “requires an investment adviser to provide investment advice in the best interest of its client, based on the client’s objectives,” and that the duty of loyalty requires 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.”

The Final Interpretation makes it clear that these duties do not exist in a vacuum: it emphasizes that the fiduciary duty “follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement.” The Final Interpretation also recognizes that investment advisers provide a wide range of services to a wide range of clients, “from retail clients with limited assets and investment knowledge and experience to institutional clients with very large portfolios and substantial knowledge, experience, and analytical resources.”

Of particular interest to private fund and institutional managers, the Final Interpretation provides the following guidance:

- The obligations of an adviser providing comprehensive, discretionary advice in an ongoing relationship with a retail client are “significantly different” from the obligations of an adviser to a private fund “where the contract defines the scope of the adviser’s services and limitations on its authority with substantial specificity (*e.g.*, a mandate to manage a fixed income portfolio subject to specified parameters, including concentration limits and credit quality and maturity ranges).”
- Disclosure to an institutional client (including the specificity, level of detail, and explanation of terminology) “can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications.”

The SEC’s recognition of the important differences between retail and institutional clients will likely be important to the application of the Final Interpretation.

The Duty of Care

The duty of care includes, among other things: (i) the duty to provide advice that is in the best interest of the client, (ii) the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades, and (iii) the duty to provide advice and monitoring over the course of the relationship.

The Final Interpretation's approach to the duty of care is largely unchanged from the Proposed Interpretation. It focuses in particular on the steps that an adviser should take to have a reasonable understanding of the client's objectives in order to provide the client with suitable investment recommendations. In this respect, in comparison to the Proposed Interpretation, the Final Interpretation focuses on the need to have an understanding of a client's investment objectives in contrast to the client's investment profile. This approach was taken in response to comments that, in the case of an institutional client, the focus should be on the client's investment objective, which can be ascertained through the mandate that the client has given the investment adviser, and that the adviser need only understand the institutional client's objective within that mandate and not its entire investment portfolio.

Similarly, an investment adviser whose client is a registered investment company or a private fund would need to have a reasonable understanding of the fund's investment guidelines and objectives. The Final Interpretation also confirms that an adviser's obligation to periodically update a client's objectives does not apply to an adviser acting on a specific investment mandate for an institutional client, particularly a fund, except as may be set forth in the advisory agreement.

Many of the observations in the Final Interpretation focus specifically on the discharge of this duty to retail clients (a term which is not defined). In the case of a retail client, the Final Interpretation notes, among other things, that whereas a high-risk investment may be appropriate for the risk tolerance of a sophisticated client, an adviser would be required to "apply heightened scrutiny to whether such investments fall within the retail client's risk tolerance and objectives." The Final Interpretation also clarifies that an adviser's duty of care "applies to all investment advice the investment adviser provides to clients, including advice about investment strategy, engaging a sub-adviser, and account type." As such, when providing advice about whether to open or invest in certain types of accounts, "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 interest."

The Duty of Loyalty

As noted above, the duty of loyalty requires an adviser to “not subordinate its client’s interest to its own” and to “make full and fair disclosure of all conflicts of interest which might influence 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 Final Interpretation clarifies certain aspects of this duty, addressing many concerns raised by comments concerning the Proposed Interpretation. The Final Interpretation also includes examples designed to clarify the application of the duty.

Some commenters had interpreted the Proposed Interpretation as suggesting that some conflicts are too complex to be addressed with full and fair disclosure; however, the Final Interpretation appears to clarify that this view was not the intended guidance and that the focus should be on the clarity of the disclosure, such that “a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent.”

In addition, the Final Interpretation notes that inadequate disclosures would include: (i) disclosure that an adviser has “other clients” without describing how the adviser will manage conflicts and (ii) the use of the term “may” in describing conflicts or potential conflicts. For example, the Final Interpretation confirms that the use of the term “may” is inappropriate when the conflict actually exists with respect to some (but not all) situations.

The Final Interpretation also recognizes that the sophistication of a client may be considered in determining whether a disclosure is full and fair. For example, institutional clients “generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications.”

The Proposed Interpretation created some confusion as to whether an investment adviser was required to make an affirmative determination as to whether each client understood the conflict prior to receiving its informed consent. The Final Interpretation explains that advisers are not required “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, 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. The Final Interpretation also states that informed consent can be explicit (*e.g.*, in writing in an advisory contact) or implicit (*e.g.*, by entering into or continuing an advisory relationship with the adviser), depending on the circumstances (which may include the sophistication of the client).

Nevertheless, the Final Interpretation states that it would not be appropriate for an adviser “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.” As such, informed consent from *retail* clients may be difficult for complex or extensive conflicts if the disclosure is not sufficiently specific and understandable. In such circumstances where full and fair disclosure may not be possible, such that a client cannot provide informed consent, an adviser “should either eliminate the conflict or adequately *mitigate* (e.g., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible.”

The Final Interpretation also clarifies an adviser’s duties in connection with the allocation of investment opportunities. The Proposed Interpretation noted that “in allocating investment opportunities among eligible clients, an adviser must treat all clients fairly.” Some commenters had suggested that this statement could be interpreted to mean that “it would be impermissible for an adviser to allocate a particular investment to one eligible client instead of a second eligible client, even when the second client had received full and fair disclosure and provided informed consent to” such allocation.

The Final Interpretation addresses this point with a more fulsome discussion on the allocation of investment opportunities, and notes that, when allocating investment opportunities among eligible clients, “an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship.” This may include an agreement that certain investment opportunities “will not be allocated or offered to a client.” The Final Interpretation does not dictate any specific method of allocation, but instead reinforces that an “adviser’s allocation practices must not prevent it from providing advice that is in the best interest of its clients.”

Hedge Clauses and Waivers of Fiduciary Duty

The Final Interpretation makes clear that an adviser’s *federal* fiduciary duty may not be waived, though its application may be shaped by agreement. In this respect, the Final Interpretation explains that a contract provision purporting to waive the adviser’s federal fiduciary duty, such as through a contract which includes “(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 obligations under the Advisers Act, would be inconsistent with the Advisers Act.” Importantly, the Final Interpretation states that the SEC does not take a position on the scope or substance of any fiduciary duty that applies to an adviser under applicable state law.

Some commenters indicated that previous actions by the SEC staff seemed to suggest that investment advisers could disclaim their fiduciary duty, in particular pointing to the “Heitman Letter,”⁵ which addressed the question of whether the inclusion of a “hedge clause” (or a clause in an advisory agreement that limits an adviser’s liability under the agreement) in an investment management agreement was *per se* misleading under the Advisers Act.

In response to these comments, the Final Interpretation reiterates that the question of whether a hedge clause violates the antifraud provisions of the Advisers Act “depends on all of the surrounding facts and circumstances, including the particular circumstances of the client,” acknowledging specifically a client’s sophistication. The Final Interpretation states that “there are few (if any) circumstances in which a hedge clause in an agreement with a *retail* client would be consistent” with the antifraud provisions of the Advisers Act. It confirms that whether a hedge clause in an agreement with an institutional client would violate the Advisers Act’s antifraud provisions will be determined based on the particular facts and circumstances, consistent with the Heitman Letter. (Given this SEC interpretation, the Heitman Letter has been withdrawn.) The Final Interpretation also notes that, to the extent that a hedge clause creates a conflict of interest between an adviser and its client, the adviser must address the conflict as required by its duty of loyalty.

Further Regulation—Not for Now

The Proposed Interpretation sought comment on potential “enhancements” to the regulation of investment advisers in areas such as licensing, continuing education and financial responsibility requirements. The Final Interpretation notes that the SEC is continuing to evaluate the comments on these suggested enhancements. It seems unlikely that the SEC will pursue these initiatives in the near future.

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The Final Interpretation reaffirms existing law and disclosure practices. Nevertheless, investment advisers should continue to review their disclosures, particularly with respect to conflicts of interest, to determine whether they should be supplemented in light of the guidance in the Final Interpretation. An adviser should also review the disclosures that have been provided to clients concerning “hedge” clauses and similar limitations on liability. Lastly, investment advisers should review and evaluate the processes through which they fulfill their duty of care to their clients.

⁵ Heitman Capital Management, LLC, SEC Staff No-Action Letter (Feb. 12, 2007).

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Please do not hesitate to contact us with any questions.

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