

SEC Proposes Clarification Regarding Fiduciary Duties Owed by Investment Advisers

Introduction

In a series of three proposed regulations¹ with requests for comments, the Securities and Exchange Commission (SEC) seeks to enhance and clarify the standards of conduct and duties owed by broker-dealers and investment advisers to their customers and clients. This Alert addresses Release No. IA 4889 (IA Release) proposed under the Investment Advisers Act of 1940, as amended (the Adviser's Act), in which the SEC proposes and requests comments from the public regarding its interpretation of the standard of conduct for investment advisers under the Advisers Act. According to the IA Release, the SEC does not intend to change the current standard of conduct applicable to investment advisers. Rather, the SEC seeks to reaffirm and clarify certain aspects of the fiduciary duty that investment advisers owe their clients under Section 206 of the Adviser's Act.

Currently, federal law imposes a fiduciary standard, based on equitable common law principles, governing the relationship between an investment adviser and its clients. The fiduciary standard is enforced under the anti-fraud provisions of Section 206 of the Advisers Act. The SEC divides this fiduciary duty into two distinct, yet dependent, obligations: the duty of care and the duty of loyalty. An investment adviser must satisfy both components to meet the required standard of conduct.

Duty of Care

Under the proposed interpretation, the duty of care requires investment advisers to (i) provide advice that is in the client's best interest, (ii) seek the best execution of the client's transactions when selecting broker-dealers to execute the client's trades, and (iii) continue to provide advice and monitoring over the course of the advisory relationship. Each of these requirements is summarized below.

- To provide advice that is in a client's best interest, the investment adviser must make a reasonable inquiry into the client's investment profile. The specific scope of this reasonable inquiry will turn on the facts and circumstances for each client. However, the proposed interpretation lists certain information that likely would be included in all inquiries: the client's current income, investments, assets and debts, marital status, insurance policies, and financial goals. With this information in mind, the investment adviser must reasonably believe that its advice is both suitable for the client and in the client's best interest.
- Under the proposed interpretation, an adviser must also try to maximize value when selecting a broker-dealer to execute the client's transactions. This means executing the transaction such that the total costs or proceeds in each transaction are the most favorable under the circumstances. To maximize value, an adviser should consider the value of research provided by the broker, execution capability, commission rate, financial responsibility, and responsiveness to the adviser.
- Finally, the duty of care component of the proposed interpretation would require that an adviser continue to provide advice and monitoring over the course of the relationship with a client. This continuing duty would specifically attach for ongoing advisory relationship. However, the adviser and client could agree to limit the scope of the relationship.

Under the proposed interpretation, an investment adviser's conduct must adhere to all three prongs to satisfy the duty of care: provide advice in the best interest of the client; seek the best execution; and monitor and advise.

Duty of Loyalty



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Related Practice Areas

- Corporate
- Securities

An investment adviser's fiduciary duty under the proposed interpretation also includes a duty of loyalty. This duty requires that an adviser place its client's interest ahead of its own, make full and fair disclosure of all material facts relating to any advisory relationship, and avoid or disclose conflicts with their client's interests.

To serve the best interest of its clients, an adviser has an obligation not to subordinate the client's interest to its own. Additionally, an adviser cannot treat some clients favorably at the expense of other clients. The duty requires an adviser to treat all of their clients fairly. An adviser must also try to avoid conflicts of interest with its clients. Where unavoidable, the adviser would have to fully and fairly disclose all material conflicts that could impact the relationship. However, broad and expansive disclosure will not satisfy the obligation. An investment adviser's disclosure to its clients must be clear and concise, but still detailed enough for the client to make a reasonably informed decision about whether to accept or reject the conflict. If the adviser cannot adequately communicate the nature of the conflict, then the adviser would be expected to mitigate or even eliminate the conflict of interest.

Currently, the SEC requires investment advisers to deliver a brochure before entering into an advisory contract under Part 2A of Form ADV, which sets out minimum disclosure requirements.² This brochure is intended to help clients and prospective clients evaluate and select investment advisers.

Additional Requests for Comment

In the same release, the SEC also requests comment on three areas of potential enhanced investment adviser regulation: (i) federal licensing and continuing education for individual adviser representatives, (ii) delivery of account statements, and (iii) financial responsibility requirements. Each proposal would impose client protections similar to those applicable to the broker-dealer/client relationship.

Currently, federal securities laws do not require that individual investment advisers or investment adviser representatives become licensed or meet educational requirements to advise clients. Under the current scheme, each state imposes the licensing and qualification criteria it finds appropriate for investment advisers. The SEC requests comment on whether there should be federal licensing and continuing education requirements for select personnel of SEC-registered investment advisers. The federal scheme would likely preempt each state's requirement and create a system similar to FINRA obligations for broker-dealers.

The SEC also requests comment on a proposal to require investment advisers to provide account statements to all clients, regardless of whether the adviser has custody of the client's assets. The proposal seeks to make the fees and costs associated with an adviser's services more clear to clients.

Finally, the SEC seeks comment on whether the financial responsibility requirements, similar to those for broker-dealers, should apply to SEC-registered investment advisers. Unlike, broker-dealers, investment advisers are not currently subject to any net capital requirements. Investment advisers are only required to disclose when their financial conditions impair their ability to properly serve their clients. The proposal would create a minimum capital requirement that investment advisers must maintain to serve their clients.

The SEC's request for comment in each of these areas — licensing and continuing education, account statements, and financial responsibility — show an intent to harmonize investment adviser and broker-dealer regulations.

This IA Release can be found [here](#).

To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Ingrid Welch at (215) 665-4616 or iwelch@cozen.com or Greg Patton at (215) 665-5571 or cpatton@cozen.com.

¹ Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 17 C.F.R. § 275, Release No. IA-4889 (proposed April 18, 2018); Regulation Best Interest, 17 C.F.R. § 240 Exchange Act Release No. 34-83062 (proposed April 18, 2018) (proposed regulation requiring a broker-dealer making a recommendation to a retail customer would have a duty to act in the best interest of that retail customer when making the recommendation); and Form CRS Relationship Summary, 17 C.F.R. §§ 240, 249, 275, and 279, Investment Advisers Act Release No. IA-4888 (proposed April 18, 2018) (proposed regulation requiring registered investment advisers and registered broker-dealers to deliver to retail investors a client relationship summary providing information about the relationships and services the firm offers, the standard of conduct and the fees, and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events).

² See also Form CRS Relationship Summary *supra* note 1 (In this companion release, the SEC is proposing to require investment advisers to deliver to retail investors a client relationship summary, which would be added as a new Part 3 to Form ADV).