

Chapman Client Alert

May 1, 2018

Current Issues Relevant to Our Clients

SEC Proposes Interpretive Guidance for Investment Adviser Standards of Conduct

On April 18, 2018, the Securities and Exchange Commission (*the "SEC"*) released a new interpretation addressing investment advisers' fiduciary duties to their clients. The SEC's proposed interpretive guidance reaffirms and clarifies duties owed by investment advisers to their clients under Section 206 of the Investment Advisers Act of 1940 (*the "Advisers Act"*). Significantly, the proposed guidance is not intended to create new or different obligations already imposed on investment advisers, but consolidates existing requirements in one place. In addition, the SEC is seeking comment on federal licensing requirements and continuing education for investment adviser representatives; requirements for client account statements; and financial responsibility and disclosure requirements. The full text of the Commission's release announcing proposed interpretive guidance is available [here](#).

Simultaneous with its interpretive guidance regarding investment adviser standards of conduct, the Commission also proposed the following:

1. Proposed Regulation Best Interest—The proposed regulation, if adopted, would establish a federal standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, which is described in our Client Alert available [here](#).
2. Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles—New and amended rules and forms to (1) require registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors, (2) prohibit the use of the words "adviser" or "advisor" in a broker-dealer's or associated person's name or title and (3) enhance registration status disclosures made to retail investors, which are described in our Client Alert available [here](#).

Investment Advisers' Fiduciary Duty

In the interpretive guidance, the SEC reiterated that investment advisers are fiduciaries, and are held to the highest standard of conduct. The SEC also noted that investment advisers must act in the best interest of their clients. This affirmative duty requires the "utmost good faith and full and fair disclosure of all material facts."

The fiduciary duty is comprised of a duty of care and a duty of loyalty. While an investment adviser may shape the relationship with its client through contractual commitments, the adviser can never disclose or negotiate away, nor can the client waive, the federal fiduciary duty.

In the interpretive guidance, the SEC stated that the duty of care consists of the following:

- A duty to act and provide advice that is in the best interest of the client;
- A duty to seek best execution of a client's transactions, if the adviser has the responsibility to select broker-dealers to execute client trades; and
- The duty to provide advice and monitoring over the course of the relationship.

The duty to provide advice in the client's best interest requires reasonable inquiry into a client's financial situation, level of

financial sophistication, investment experience and investment objectives (collectively, the “*Investment Profile*”). The SEC stated that not only must the Investment Profile be established at the start of the client relationship; the Investment Profile must be updated to adjust to changing circumstances during the life of the relationship. In addition, the investment adviser must have a reasonable belief that the personalized advice provided to the client is suitable for, and in the best interest of the client, based on the Investment Profile. Finally, the SEC stated that while cost should play a factor into the advice given to the client, the fiduciary duty does not require an investment adviser to recommend the lowest cost investment product or strategy. Rather, the investment adviser should consider products or strategies that are suitable for the client.

Regarding the duty of best execution, the SEC is seeking to formalize previously released guidance. The SEC requires an investment adviser to seek to obtain the execution of transactions for each of its clients that are the most favorable under the circumstances. An investment adviser may fulfill this duty by executing securities transactions for a client with the goal of maximizing value for a particular transaction. However, maximizing value encompasses more than minimizing cost and the SEC continues with its prior position that investment advisers 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.” Finally, in the interpretive guidance, the SEC noted that investment advisers should periodically and systemically review execution services for their clients.

The interpretive guidance stated that the duty of on-going monitoring is especially important for advisers with on-going client relationships (*i.e.*, where the adviser is compensated with a periodic asset-based fee or has discretionary authority over client assets). However, the SEC noted that this duty may be circumscribed if the adviser and client have agreed to a relationship of limited-duration such as a fixed, one-time consultation.

As described in the interpretive guidance, the duty of loyalty requires that the adviser put the client’s interests first. Consequently, the adviser must make full and fair disclosure of all material facts related to the advisory relationship. The interpretive guidance emphasizes the need for clear disclosure that is understandable for clients. Such disclosure must allow clients to make informed decisions. To this end, the SEC is formalizing certain views, including enforcement actions such as In the Matter of The Robare Group, Ltd., which held that

disclosing an adviser “may” have a conflict is not adequate when a conflict, in fact, exists.

The SEC was careful to point out that the fiduciary duties that apply to an investment adviser are similar to, but not the same as, the “Best Interest” standard that has been proposed for broker-dealers. In particular, the SEC noted that the models of service and relationship expectations of clients are different for investment advisers than for broker-dealers. Consequently, the SEC has declined to provide a uniform standard of conduct for investment advisers and broker-dealers.

Requests for Comment Regarding Areas of Enhanced Investment Adviser Regulation

In addition to the interpretation of the fiduciary standard, the SEC requested comments on three areas where broker-dealers currently have different requirements than investment advisers:

- *Federal licensing and continuing education:* Although the SEC does not currently impose licensing standards on investment adviser representatives (note that the Series 65 is a state license administered by FINRA), FINRA imposes license and continuing education requirements on associated persons at SEC-registered broker-dealers. The SEC has requested comment on whether similar requirements should be implemented for federally registered investment adviser representatives.
- *Account statements:* Currently, federal law does not require investment advisers to provide account statements, although many do as a client service. The SEC has asked for information regarding current practices, the costs associated with providing statements and whether statements setting forth fees and expenses charged for advisory services should be mandated.
- *Financial responsibility:* The federal securities laws do not impose capital requirements on investment advisers, nor do they impose a requirement to maintain a fidelity bond. The SEC has requested comment on whether investment advisers, like broker-dealers under Rule 15c3-1 of the Securities Exchange Act of 1934, should be subject to similar requirements. In addition, the SEC requested comment on whether annual audit of investment advisor financial statements should be required and whether such information should be included on Form ADV.

What to Do Now

Comments on the proposed interpretative guidance and the other Commission proposals are due by ninety days from the date of their publication in the Federal Register.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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