

May 4, 2018

SEC Proposes Conduct Standards for Investment Advisers

On April 18, concurrently with its publication for comment of a proposed fiduciary rule for brokers,¹ the Securities and Exchange Commission (SEC) took several actions that broadly implicate investment advisers.

First, the SEC issued a release entitled “Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation.”² As the title implies, this Release has two parts, both of which are significant. Second, the SEC proposed a new disclosure document for advisers that would function similar to a consumer protection warning for retail advisory clients.

Proposed Statement of Standards of Conduct

The Release begins with a proposed statement of the standards of conduct that apply to investment advisers, which the Release stated was “to reaffirm—and in some cases clarify—certain aspects of the fiduciary duty an investment adviser owes to its clients.” While portions of this Release are not surprising, the following aspects of the statement are significant:

Differing Fiduciary Standards. The Release notes in several places that a fiduciary duty has different meanings in different legal contexts.³ This observation leaves open the question of how the SEC, and other regulators, derive different interpretations of the same legal concept. This, in turn, raises the question of how novel questions involving the interpretation of an adviser’s fiduciary duties under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) should be determined.

Mere Disclosure May Not Be Sufficient. The Release posits a number of qualifications and conditions on efforts to waive or limit an adviser’s fiduciary duties through disclosure and client consent, and suggests certain limits of effectiveness and an actual change in the adviser’s business practices may be the only means of remediation. The Release expressly notes that “the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty.” Although the Release acknowledges that disclosure to clients and their consent can satisfy an adviser’s obligations, the Release

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¹ Katten will share additional information pertaining to broker-dealers in a separate advisory.

² Adviser Act Rel. 4889 (Apr. 18, 2018) (*hereinafter*, the “Release”).

³ “An investment adviser’s fiduciary duty is similar to, but not the same as, the proposed obligations of broker-dealers under Regulation Best Interest.” Release at p. 5.

“In various circumstances, other regulators, including the U.S. Department of Labor, and other legal regimes, including state securities law, impose obligations on investment advisers. In some cases, these standards may differ from the standard imposed and enforced by the Commission.” Release at p. 8, n. 22.

imposes numerous limitations on this process and presents several serious cautions on an adviser's efforts to cure a breach of duty through disclosure and client consent:

- a) disclosure of the conflict must be "clear and detailed" and must disclose "sufficiently specific facts;"
- b) disclosing that an adviser "may" have a conflict is insufficient "when the conflict actually exists;"
- c) implicit client consent is not sufficient if "the facts and circumstances indicate that the client did not understand the nature and import of the conflict" or if "the material facts concerning the conflict could not be fully and fairly disclosed;" and
- d) "complex or extensive conflicts" where disclosure that is "sufficiently specific" may not be "understandable to the adviser's clients," may not be capable of cure through disclosure and consent. These conflicts require the adviser to "eliminate" or "adequately mitigate" the conflict so that it can be more readily disclosed.

More Guidance Needed from the SEC. The Release remains largely ambiguous on the circumstances in which the SEC would deem disclosure and consent to be insufficient to cure an adviser's conflict of interest, providing no specific examples of such seemingly "incurable" conflicts, nor any elaboration on the factors that an adviser should consider in evaluating whether informed consent is possible and will be respected. Given that the Release is positioned by the SEC as a clarification of its existing positions on an adviser's fiduciary duty—which the Release notes "follows the contours of the relationship between the adviser and its client" and may be shaped "through contract when the client receives full and fair disclosure and provides informed consent,"⁴ rather than a change in law—Katten anticipates that commenters will focus on this aspect of the Release and seek further guidance on this apparent change in emphasis by the SEC.

Emphasis on Duty of Care. The Release places a greater emphasis on an adviser's duty of care than had been present in other SEC releases and enforcement actions, almost all of which involve alleged breaches of the duty of loyalty. For example, the Release:

- presents a listing of the information an adviser must gather to make a suitability determination for a client;⁵
- expressly states that "[a]n adviser must update a client's investment profile in order to adjust its advice to reflect any changed circumstances;"⁶
- notes that the adviser should consider the costs associated with investment opportunities (although "the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy");⁷ and
- asserts that an adviser must "conduct a reasonable investigation into the investment sufficient to not base its advice on materially inaccurate or incomplete information."⁸

This articulation of an adviser's suitability obligations closely mirrors the FINRA standards for broker-dealers and is more detailed than articulations of the standard that have appeared before. The Release also emphasizes that "[a]n adviser is required to provide advice and services to a client over the course of the relationship at a frequency that is both in the best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client."⁹

Possible Enhancements to Advisory Regulation

The Release requests comment on three possible enhancements to the regulation of advisers.

⁴ Release at p. 8.

⁵ "[T]he duty of care includes a duty to make a reasonable inquiry into a client's financial situation, level of financial sophistication, investment experience, and investment objectives (which we refer to collectively as the client's "investment profile") and a duty to provide personalized advice that is suitable for and in the best interest of the client based on the client's investment profile." Release at pp. 9-10.

⁶ Release at p.10.

⁷ Release at p. 12.

⁸ Release at p. 13.

⁹ Release at pp. 14-15.

1. **Federal Licensing.** “[W]hether there should be federal licensing and continuing education requirements for personnel of SEC-registered investment advisers.”¹⁰ The Release more generally asks whether “other types of qualification requirements should be considered, such as minimum experience requirements or standards regarding an individual’s fitness for serving as an investment adviser representative.”¹¹
2. **Periodic Account Statements.** [W]hether advisers should be required to provide periodic account statements to their clients and “whether we should propose rules to require registered investment advisers to provide account statements, either directly or with the client’s custodian, regardless of whether the adviser is deemed to have custody of client assets under Advisers Act.” The Release states that the SEC “believe[s] that delivery of periodic account statements, if they specified the dollar amounts of fees and expenses, would allow clients to readily see and understand the fees and expenses they pay for an adviser’s services.”¹² The Release also asked “[w]hat information, in addition to fees and expenses, would be most useful for retail clients to receive in account statements?”
3. **Financial Standards.** “[W]hether SEC-registered investment advisers should be subject to financial responsibility requirements along the lines of those that apply to broker-dealers” and whether “advisers be required to obtain a fidelity bond from an insurance company.”¹³ With respect to a net capital requirement, the Release specifically requests comment on whether the North American Securities Administrators Association Minimum Financial Requirements For Investment Advisers Model Rule 202(d)-1 provides a good model for a net capital requirement for advisers.¹⁴

Scope of Proposals Unclear. While certain of the SEC’s contemplated enhancements, particularly with respect to the provision of periodic account statements, include references to “retail clients,” the Release does not explicitly state whether these changes are likely to be focused on, or limited to, advisers with a retail client base, or whether they would apply equally to advisers managing private funds or other institutional assets. Katten expects industry associations and other interested commenters in these industry segments to address the relative import of certain of the proposed enhancements for their respective client bases. For example, the detailed disclosures and periodic financial reporting typically provided to investors in private funds (not themselves “clients” under the Advisers Act) and institutional investors, who customarily require due diligence information far beyond those proposed in the Release, may obviate the perceived benefits of certain of the SEC’s proposals in those cases.

New Disclosure Form for Advisers

The SEC also proposes a new Form CRS, which is a client relationship summary disclosure document.¹⁵ This disclosure form would have to be prepared by broker-dealers, dually registered broker-dealers and advisers, and even by registered advisers that are not registered as broker-dealers. For registered investment advisers, the Form CRS also is known as the Form ADV Part 3.

The form would have to be delivered to all “retail investors” of an adviser, a term that is defined in proposed Advisers Act Rule 204-5 as “a client or prospective client who is a natural person (an individual). This term includes a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust.”

The Form would present a short, plain English description of whether an advisory relationship is right for the customer. Much of the content of the form mirrors Form ADV, Part 2A, although the form would be shorter and clearer than the existing Part 2A. The form

¹⁰ Release at p. 29.

¹¹ Release at p. 31.

¹² Release at p. 31.

¹³ Release at pp. 35-36.

¹⁴ Release at p. 37. The NASAA provision “requires, among other things, an investment adviser who has custody of client funds or securities to maintain at all times a minimum net worth of \$35,000 (with some exceptions), an adviser who has discretionary authority but not custody over client funds or securities to maintain at all times a minimum net worth of \$10,000, and an adviser who accepts prepayment of more than \$500 per client and six or more months in advance to maintain at all times a positive net worth.”

¹⁵ Advisers Act Rel. 4888.

also would perform a consumer protection function that Form ADV currently does not perform. Essentially, the form would warn a customer to consider whether an advisory relationship is really in the customer's best interests.

The form would include the following information:

- a description of the advisory relation and the services offered by the adviser;
- a summary of the adviser's obligations to the customer;
- a very high-level summary of the fees and costs the customer will pay;
- a comparison of the advisory services with brokerage services. This type of description does not appear in Form ADV Part 2A. It invites the customer to consider whether an advisory relationship is really in the customer's best interests;
- a high level summary of the adviser's conflicts of interest;
- information on how to obtain more information about the adviser; and
- a listing of "key questions to ask":
 1. "Given my financial situation, why should I choose an advisory account?"
 2. Do the math for me. How much would I pay per year for an advisory account? What would make those fees more or less? What services will I receive for those fees?
 3. What additional costs should I expect in connection with my account?
 4. Tell me how you and your firm make money in connection with my account. Do you or your firm receive any payments from anyone besides me in connection with my investments?
 5. What are the most common conflicts of interest in your advisory accounts? Explain how you will address those conflicts when providing services to my account.
 6. How will you choose investments to recommend for my account?
 7. How often will you monitor my account's performance and offer investment advice?
 8. Do you or your firm have a disciplinary history? For what type of conduct?
 9. What is your relevant experience, including your licenses, education, and other qualifications? Please explain what the abbreviations in your licenses are and what they mean.
 10. Who is the primary contact person for my account? What can you tell me about his or her legal obligations to me? If I have concerns about how this person is treating me, who can I talk to?"

The SEC's proposals reflect significant changes to current investment advisory and broker-dealer regulation. Undoubtedly, the process of reviewing these proposals will elicit vigorous comments and extended debate. The deadlines for submitting comments to the Release and the Form CRS release will be set 90 days after their respective publication dates in the *Federal Register*, which have not yet occurred at the time of this writing.

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