GREENWICH COMPLIANCE

SPOTLIGHT ON

Investment Advisers Act of 1940 –
Fiduciary Duty

Advisers Act Fiduciary Duty

Under the Investment Advisers Act of 1940 (the "Advisers Act"), an investment adviser owes a fiduciary duty to its clients.[1] The duty comes from "the sensitive nature of the relationship between an investment adviser and its clients – a relationship based on trust that requires a higher legal standard of care." The fiduciary duty is an overarching legal duty that requires an investment adviser to place the interests of its clients ahead of its own interests.

The fiduciary duty stems from a "combination of the nature of the advisory relationship and the broad antifraud provisions of the law that prohibit an investment adviser from engaging 'in any act, practice or course of business which is fraudulent, deceptive, or manipulative.'" Investment Advisers Act of 1940, Sec. 204(d).

Section 206 of the Advisers Act imposes a "fiduciary duty" on investment advisers with respect to their relationship of trust and confidence with their advisory clients. Although the Advisers Act never explicitly states that an investment adviser is a fiduciary, the Supreme Court ruled in the landmark case, *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) ("*Capital Gains*").

The purpose of the fiduciary duty is to eliminate (or mitigate) all conflicts of interest and to prevent an adviser from abusing a client's trust. An adviser has an affirmative duty of utmost good faith to act solely in the best interests of the client and to make full and fair disclosure of all material facts.

An adviser must, at all times, act in the best interest of the client and ensure that it is not providing less than disinterested advice, consciously or unconsciously. An adviser may be found liable of violating the anti-fraud provisions of the Advisers Act even where the adviser did not intend to injure a client or even if the client does not suffer a monetary loss.

"The investment adviser's fiduciary duty is broad and applies to the entire adviser-client relationship."[2] "It is made enforceable by the antifraud provisions of the Advisers Act."[3]

The fiduciary duty owed by advisers to their clients, under the Advisers Act, is composed of two duties: (1) a duty of care, and (2) a duty of loyalty.[4]

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[1] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963); *See also*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. IA-5248 2, 6 n.15 (June 5, 2019).

[2] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No.IA-5248 2, 6 n.17 (June 5, 2019).

[3] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No.IA-5248 2, 6 n.20 (June 5, 2019).

Duty of Loyalty. The duty of loyalty requires that an adviser:

- Serve the best interest of its clients;
- Subrogate its own interests to that of its clients; and
- Fully disclose and eliminate or mitigate conflicts of interests.

Duty of Care. An adviser's duty of care requires that an adviser provide suitable advice and "make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[5]

Other Duties. The fiduciary duty also encompasses the obligations to act in its clients' best interest and make full and fair disclosure to clients of all material facts. The following additional duties and obligations also flow from the Advisers Act fiduciary duty:

- **Best Interest of Clients**. The duty to place the clients' interests first;
- **Advice**. The duty to have an adequate, reasonable basis for its investment advice;
- **Suitability**. The duty to inform itself about clients' situations and circumstances;
- **Competence**. The duty to use only those strategies for which the adviser is reasonably competent;
- **Client Objectives**. The duty to follow client instructions, guidelines and governing documents;
- **Supervision**. The duty to create policies and procedures reasonably designed to supervise persons with a view to preventing violations of the federal securities laws;
- **Due Diligence**. The duty to exercise due diligence on subadvisors and other third parties;
- **Best Execution**. The duty to seek best execution for clients' securities transactions where the adviser directs such transactions;
- **Proxy Voting**. The duty to vote proxies in the best interests of clients;
- **Allocation**. The duty to allocate investment opportunities fairly among clients;
- **Personal Activities**. The duty not to subrogate clients' interests to its own;
- **Misappropriation/Soft Dollars**. The duty not to use client assets' for itself; and
- **Confidentiality**. The duty to maintain client confidentiality.

In short, the fiduciary duty means that:

> *in the course of providing advice to clients, advisers must disclose all material information and conflicts of interests to their clients, including the fees that they charge, how they plan to recommend securities to clients, and any material disciplinary information involving the firms or their investment personnel. Moreover, as fiduciaries, advisers must treat their clients fairly and not favor one*

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[4] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No.IA-5248 2, 6 n.21 (June 5, 2019).

[5] SEC, "Study on Investment Advisors and Broker-Dealers, as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act," page 22.

client over another, especially if they would somehow benefit from favoring one particular client or type of client. More important, whenever the interests of investment advisers differ from those of their clients, advisers must explain the conflict to the clients and act to mitigate or eliminate it, ensure they act in the interests of the client and not for their own benefit.[6]

These duties apply to all investment advisers, regardless of whether they are registered with the SEC or state securities authorities or not.[7] The Advisers Act applies irrespective of registration. Thus, they apply to advisers relying on any exemptions from registration, such as the Private Fund Adviser exemption. They also apply to advisers who provide discretionary management services as well as those advisers who solely provide impersonal investment advice.

[6] KAREN BARR AND DAVID TITTSWORTH, DAVID H. LUI, JOHN J. WALSH AND KASON K. MITCHELL MODERN COMPLIANCE: BEST PRACTICES FOR SECURITIES & FINANCE, 84 (2015).

[7] Any person (individual or entity) that meets the definition of an investment adviser.

GREENWICH COMPLIANCE

SPOTLIGHT ON

Investment Advisers Act of 1940 – Standards of Conduct: Final Rulemaking Package

Standards of Conduct – Overview of Final Rulemaking Package for Advisors

On June 5, 2019, the Securities and Exchange Commission (the "SEC") issued an interpretative release under the Investment Advisers Act of 1940 ("Advisers Act"), *Regarding Standard of Conduct for Investment Advisers* (the "Interpretation"). The Interpretation clarifies and reaffirms certain aspects of the fiduciary duty and associated obligations Advisers owe to their clients under the Advisers Act.

The Interpretation provides that the fiduciary duty under the Advisers Act is a principles-based duty, which applies to the entire relationship between an adviser and its clients. The fiduciary duty owed by advisers to their clients, under the Advisers Act, is composed of two underlying component duties: (1) a *duty of care*, and (2) a *duty of loyalty*.[8] An adviser must comply with the component duties in order to meet its fiduciary duty. The Interpretation also addresses these two underlying component duties that constitute an adviser's fiduciary duty:

- *Duty of Care* is composed of three core duties:

    - *The duty to seek best execution*;
    - *The duty to provide advice and monitoring over the course of the adviser-client relationship*; and
    - *The duty to provide advice that is in the best interest of the client*.

    The last duty, the duty to provide advice that is in the best interest of the client, requires that the adviser have a *reasonable belief that the advice is in the best interest of the client*.

- *Duty of Loyalty* requires that an adviser must not subordinate its clients' interests to its own interests. Additionally, an adviser must:

    - Disclose all material facts relating to the advisory relationship; and
    - Eliminate, or make full and fair disclosures of, all conflicts of interest, which might incline an investment adviser, consciously or unconsciously, to render advice, which is not disinterested.

[8] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No.IA-5248 2, 6 n.21 (June 5, 2019).

For a disclosure to be considered full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether or not to provide consent.

The Advisers Act does not provide for a fiduciary standard (in either its statutory or rules-based text). "The relationship between an investment adviser and its client has long been based on fiduciary principles not generally set forth in specific statue or text." The Interpretation cites the 1963 Supreme Court opinion in *SEC v. Capital Gains Research Bureau Inc.* as well as selected references to certain SEC releases (without any direct citation and/or reliance on the Advisers Act). The SEC has consolidated "long-recognized, court established fiduciary duties into the interpretive release." The implication is that advisers should have been adhering to this amalgamation of guidance and court-established fiduciary duties to understand the duties owed to clients as the Interpretation merely consolidates preexisting guidance and principles.

Advice on Selection of Account Types (Rollovers).

The Interpretation makes clear that the fiduciary duty applies to "all investment advice the investment adviser provides to its clients" including account type:

> *Advice about account type includes advice whether to open or invest through a certain type of account (e.g., a commission-based brokerage account or a fee-based advisory account) and advice about whether to roll over assets from one account (e.g., a retirement account)) into a new or existing account that the adviser or an affiliate of the adviser manages. In providing advice about account type, an adviser should consider all type 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*.[9]

The Interpretations provides that the SEC considers "advice about 'Rollovers' to include advice about account type, in addition to any advice regarding the investments or investment strategy with respect to the assets to be rolled over, and the advice necessarily includes the advice about the account type into which the assets are to be rolled over."[10]

Lowest Cost v. Highest Cost Recommendations.

The Interpretation reaffirms the view that recommending the lowest-cost product or strategy is not required. The Interpretation states: "When considering similar investment products or strategies, the fiduciary duty does not necessarily require an adviser to recommend the lowest-cost investment product or strategy."[11] However, where the lowest-cost investment or strategy

[9] SEC, CFR Part 276 (Release No. IA-5248; File No. S7-07-17 - 8, fn 42, June 5, 2019).
[10] Id at 18.
[11] Id at 17.

is not recommended, the adviser should consider ”other factors about the investment or strategy in the best interest of the client, in light of that client’s objectives.”

The Term “May” in Conflict Disclosures.

The use of the term “may” is not adequate when the conflict actually exists. The use of the term is wholly inadequate where a conflict actually exists and where it is employed to describe possible/potential conflicts.” The Interpretation notes that the use of the term “may” “obfuscates actual conflicts to the point that a client cannot provide informed consent.”

However, the SEC has stated that the use of the term “may” could be appropriately used to disclose a potential conflict that might reasonably appear in the future, but does not currently exist.

Standards of Conduct – Detailed Review of Final Rulemaking Package for Advisors

The Securities and Exchange Commission (the "SEC") issued the final Standards of Conduct rulemaking package on June 5, 2019. The Standards of Conduct rulemaking package is intended to: **(1)** heighten the standard of conduct to which broker-dealers must adhere; **(2)** reaffirm certain aspects of the fiduciary duty under the Advisers Act; and **(3)** reduce client uncertainty regarding the standards of conduct applicable to their adviser or broker and as well as the nature of the services they offer.

Advisers Act Fiduciary Duty.

The Interpretation reiterates that the fiduciary duty advisers owe to their clients under this Advisers Act is a principles-based duty based on two affirmative underlying duties: (1) the Duty of Care, and (2) the Duty of Loyalty.

Together the two duties create the overarching fiduciary duty, which requires an adviser to act in the best interest of their clients.

The fiduciary duty applies to the entire relationship between the adviser and its clients. The duty follows the contours of the adviser-client relationship, which may be shaped by an agreement between the adviser and the client, subject to full and fair disclosure and informed consent.

Scope of Relationship and Waivers.

An adviser's federal fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the adviser-client relationship. The specific obligations the adviser owes to a client depend on what services and functions the adviser has agreed to perform for or provide to the client. "While the application of the investment adviser's fiduciary duty will vary with the scope of the relationship, the relationship in all cases remains that of a fiduciary to the client."[12] The fiduciary duty and obligations that flow from it cannot be waived or limited by agreement. The question of whether a hedge clause violates the Advisers Act depends on the facts and circumstances of the particular client and the relationship between the adviser and the client.

[12] SEC, CFR Part 276 (Release No. IA-5248; File No. S7-07-17, 10, June 5, 2019).

The Duty of Care.

“The duty of care requires an investment adviser to provide investment advice in the best interest of its clients, based on the clients’ objectives” The Duty of Care is composed of three major elements:

1. The duty to provide advice that is in the best interest of the client;
2. The duty to seek best execution of a client’s transactions where the adviser has the responsibility to select the broker-dealer to execute client trades; and
3. The duty to provide advice and monitoring over the course of the relationship.

Duty to Provide Advice in Best Interest of Client. The interpretation outlines that an adviser must provide clients with advice that is *suitable* and based on a *reasonable belief that the advice is in the best interest of the client*. This requires that an adviser conduct a “reasonable inquiry into the client’s objectives”. The Interpretation clarifies that the standard for “reasonable inquiry” differs between retail and institutional clients.

Reasonable Inquiry. The scope of the inquiry should generally be informed by the specific facts and circumstances of the client, “including the nature of the client, the scope of the adviser-client relationship, and the nature and complexity of the anticipated investment advice.”

A reasonable inquiry requires that an adviser develop a reasonable understanding of the client’s objectives. The basis for a “reasonable understanding” differs between retail and institutional clients. Generally, reasonable understanding requires the adviser possess, “for retail clients, an understanding of the investment profile, or for institutional clients, an understanding of the investment mandate.”[13]

Retail Clients. An adviser should, at a minimum consider “the client’s financial situation, level of financial sophistication, investment experience, and financial goals”, in order to gain a reasonable understanding of a retail client’s objectives.[14] Generally, this may be achieved through the creation, maintenance, and adjustment of a retail client’s **investment profile** on an ongoing basis.

> EXAMPLE:
> “An adviser undertaking to formulate a comprehensive financial plan for a retail client would generally need to obtain a range of personal and financial information about the client such as current income, investment, assets and debts, marital status, tax status, insurance policies, and financial goals.”
>
> “In the case of a financial plan where the investment adviser also provides advice on an ongoing basis, a change in relevant tax law or knowledge that the client has retired or

[13] SEC, CFR Part 276 (Release No. IA-5248; File No. S7-07-17, 13, June 5, 2019).
[14] Id.

> experienced a change in material status could trigger an obligation to make a new inquiry."

Institutional Clients. The nature and the extent of a reasonable inquiry into an institutional client's objectives should be generally guided by the client's "specific investment mandates". Additionally, unless set out in the advisory agreement between the institutional client and the adviser, there is no obligation for the adviser to update the client's objectives on an ongoing basis.

> EXAMPLE:
> "An Investment adviser engaged to advise on an institutional client's investment grade bond portfolio would need to gain a reasonable understanding of the client's objectives within that bond portfolio, but not the client's objectives within its entire investment portfolio."
>
> "An 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."

Reasonable Belief.

"An investment adviser must have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives." The adviser must assess the advice in the context of the services the adviser is providing the client. Where an adviser is providing portfolio management services, that adviser would consider "whether investments are recommended only to those clients who can and are willing to tolerate the risks of those investments and for whom the potential benefits may justify the risks." For example, an adviser should consider the complexity and relative risk of a product, the need for daily monitoring as well as the client's level of sophistication.

Furthermore, an adviser must conduct "a reasonable investigation into the investment" that is sufficient enough to ensure that the adviser's advice is not based on materially inaccurate or incomplete information.

> EXAMPLE:
> When an adviser is advising a retail client with a conservative investment objective, investing in certain derivatives may be in the client's best interest when they are used to hedge interest rate risk or other risks in the client's portfolio, whereas investing in certain directionally speculative derivatives on their own may not.

When advising a financially sophisticated client, such as a fund or other sophisticated client that has an appropriate risk tolerance, it may be in the best interest of the client to invest in such derivatives or in securities on margin, or to invest in other complex instruments or other products that may have limited liquidity.

When an adviser is assessing whether high-risk products – such as penny stocks or other thinly - traded securities – are in a retail client's best interest, the adviser should generally apply heightened scrutiny to whether such investments fall within the retail client's risk tolerance and objectives.

An adviser's fiduciary duty applies to all investment advice including the following:

- Investment strategies;
- Engagement of a sub-adviser; and
- Account types[15].

*__The Duty to Seek Best Execution__***.** The Interpretation reaffirms that the duty of care also includes the duty to seek best execution for client transactions where the adviser has the discretion to select broker-dealers to execute client trades. An adviser must "seek to obtain the execution of transactions for each of its clients such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances." In order the accomplish this, an adviser must seek to maximize the "value for the client under the particular circumstance occurring at the time of the transaction." This is more than just minimizing cost, it requires that the adviser 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' to the adviser." In short, the analysis is qualitative not quantitative. Advisers should expand their assessment beyond achieving the "lowest possible commission cost" to considering "whether the transaction represents the best qualitative execution." This assessment should be conducted on a periodic and systematic basis.

__Duty to Provide Advice and Monitoring Over the Course of the Relationship__. The Duty of Care requires that an adviser "provide advice and monitoring at a frequency that is in the best interest of the client taking into account the scope of the agreed relationship."

As previously discussed, the adviser's fiduciary duty and obligations thereunder are directly controlled by the scope and nature of the adviser's relationship with the client. "An adviser and client may scope the frequency of the adviser's monitoring (monthly, or quarterly) and as appropriate in between based on market events), provided that there is full and fair disclosures and informed consent."

EXAMPLE:

[15] This includes advice about "whether to open or invest through a certain type of account (e.g., a commission-based brokerage account or a fee-based advisory account) and advice about whether to roll over assets from one account (e.g., a retirement account) into a new or existing account that the adviser or an affiliate of the adviser manages" Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No.IA-5248 2, 18 (June 5, 2019).

> When the adviser has an ongoing relationship with a client and is compensated with a periodic asset-based fee, the adviser's duty to provide advice and monitoring will be relatively extensive as is consistent with the nature of the relationship.

The Interpretation notes that the frequency of monitoring "as well as any other material facts relating to the agreed frequency [*i.e.*, whether there will be interim monitoring when there are market events]" is a material fact of the advisory relationship for which full and fair disclosure and informed consent are required.

If the adviser and client have not agreed to place any specific limitations or expansions, the adviser's obligation to monitor will be governed by the "duration and nature of the agreed advisory arrangement." This extends to all personalized advice the adviser provides the client "including for example… an evaluation of whether a client's account or program type…continues to be in the client's best interest."

The Duty of Loyalty.

"The duty of loyalty requires that an adviser not subordinate its client's interests to its own."

Under the duty of loyalty an adviser must:

1. Place the client's interests first; and
2. Make full and fair disclosure to their clients of all material facts relating to the advisory relationship, including disclosure of the capacity in which the firm is acting.

<u>Full and Fair Disclosure.</u> An adviser must either eliminate or provide full and fair disclosure of all conflicts of interest "which might incline an adviser – consciously or unconsciously, - to render advice which is not disinterested. Clients must provide informed consent to the disclosure(s). The disclosure(s) of all material facts relating to the advisory relationship or conflicts of interests and the client's informed consent prevent the facts or conflicts from violating the adviser's fiduciary duty.

For example, firms or individuals that are (1) dually registered as broker-dealers and investment advisers *and* (2) who serve the same client in both an advisory and a brokerage capacity, generally should provide disclosure about the circumstances in which they intend to act in their brokerage capacity and in their advisory capacity. "A dual registrant acting in its advisory capacity should disclose any circumstances under which its advice will be limited to a menu of certain products offered through its affiliated broker-dealer or affiliated investment adviser."

"Disclosure may be accomplished through a variety of means, including, among others, written disclosure at the beginning of a relationship that clearly sets forth when the dual registrant would act in an advisory capacity and how it would provide notification of any changes in capacity." A client's consent may be inferred. Advisers are not obligated "to make an affirmative determination that a particular client understood the disclosure and that the consent to the conflict was informed." However, such disclosure and consent do not necessarily satisfy the adviser's duty to act in the client's best interest.

In circumstances where an adviser cannot deliver adequate disclosure of a conflict to clients, so that the clients can provide informed consent," the adviser should either eliminate the conflict or adequately mitigate (i.e., modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible.

The obligation of full and fair disclosure applies to both the adviser's Form ADV Part 1 and 2 as well as the relationship summary (Form CRS).

To illustrate what constitutes full and fair disclosure the Interpretation provided guidance on (i) the appropriate level of specificity, including the appropriateness of the statement that an adviser "may" have a conflict, and (ii) considerations for disclosure regarding conflicts related to the allocation of investment opportunities among eligible clients.

The adviser must provide full and fair disclosure. It must be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision on whether to provide or not provide consent.

For example, it would be inadequate to disclose that the adviser has "other clients" without describing how the adviser will manage conflicts between clients if and when they arise, or to disclose that the adviser has "conflicts" without further description.

Similarly, disclosure that an adviser 'may' have a particular conflict, without more, is not adequate when the conflict actually exists. However, the word 'may' could be appropriately used to disclose to a client a potential conflict that does not currently exist but might reasonably present itself in the future."[16]

[16] SEC, CFR Part 276 (Release No. IA-5248; File No. S7-07-17, 25, June 5, 2019).