

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

Release No. IA-4889; File No. S7-09-18

RIN: 3235-AM36

**Proposed Commission Interpretation Regarding Standard of Conduct for Investment
Advisers; Request for Comment on Enhancing Investment Adviser Regulation**

AGENCY: Securities and Exchange Commission.

ACTION: Proposed interpretation; request for comment.

SUMMARY: The Securities and Exchange Commission (the “SEC” or the “Commission”) is publishing for comment a proposed interpretation of the standard of conduct for investment advisers under the Investment Advisers Act of 1940 (the “Advisers Act” or the “Act”). The Commission also is requesting comment on: licensing and continuing education requirements for personnel of SEC-registered investment advisers; delivery of account statements to clients with investment advisory accounts; and financial responsibility requirements for SEC-registered investment advisers, including fidelity bonds.

DATES: Comments should be received on or before August 7, 2018.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/interp.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-09-18 on the subject line.

Paper Comments:

- Send paper comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-09-18. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/interp.shtml>). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

FOR FURTHER INFORMATION CONTACT: Jennifer Songer, Senior Counsel, or Sara Cortes, Assistant Director, at (202) 551-6787 or IArules@sec.gov, Investment Adviser Regulation Office, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

SUPPLEMENTARY INFORMATION: The Commission is publishing for comment a

proposed interpretation of the standard of conduct for investment advisers under the Advisers Act [15 U.S.C. 80b].¹

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- I. INTRODUCTION

An investment adviser is a fiduciary, and as such is held to the highest standard of conduct and must act in the best interest of its client.² Its fiduciary obligation, which includes an

¹ 15 U.S.C. 80b. Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b of the United States Code, at which the Advisers Act is codified, and when we refer to rules under the Advisers Act, or any paragraph of these rules, we are referring to title 17, part 275 of the Code of Federal Regulations [17 CFR 275], in which these rules are published.

² *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) ("SEC v. Capital Gains"). *See also infra* notes 26 - 32 and accompanying text; Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256 (July 2, 2004); Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) ("Compliance Programs Release"); Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Investment Advisers Act

affirmative duty of utmost good faith and full and fair disclosure of all material facts, is established under federal law and is important to the Commission’s investor protection efforts.³ The Commission also regulates broker-dealers, including the obligations that broker-dealers owe to their customers. Investment advisers and broker-dealers provide advice and services to retail investors and are important to our capital markets and our economy more broadly. Broker-dealers and investment advisers have different types of relationships with their customers and clients and have different models for providing advice, which provide investors with choice about the levels and types of advice they receive and how they pay for the services that they receive.

Today, the Commission is proposing a rule that would require all broker-dealers and natural persons who are associated persons of broker-dealers to act in the best interest of retail customers⁴ when making a recommendation of any securities transaction or investment strategy involving securities to retail customers (“Regulation Best Interest”).⁵ We are also proposing to require registered investment advisers and registered broker-dealers to deliver to retail investors a relationship summary, which would provide these investors with 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

Release No. 1862 (Apr. 5, 2000). We acknowledge that investment advisers also have antifraud liability with respect to prospective clients under section 206 of the Advisers Act.

³ See SEC v. Capital Gains, *supra* note 2.

⁴ An investment adviser has a fiduciary duty to all of its clients, whether or not the client is a retail investor.

⁵ Regulation Best Interest, Exchange Act Release No. 34-83062 (April 18, 2018) (“Regulation Best Interest Proposal”).

financial professionals currently have reportable legal or disciplinary events.⁶ In light of the comprehensive nature of our proposed set of rulemakings, we believe it would be appropriate and beneficial to address in one release⁷ and reaffirm – and in some cases clarify – certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act.⁸

An investment adviser’s fiduciary duty is similar to, but not the same as, the proposed obligations of broker-dealers under Regulation Best Interest.⁹ While we are not proposing a uniform standard of conduct for broker-dealers and investment advisers in light of their different relationship types and models for providing advice, we continue to consider whether we can improve protection of investors through potential enhancements to the legal obligations of investment advisers. Below, in addition to our interpretation of advisers’ existing fiduciary obligations, we request comment on three potential enhancements to their legal obligations by considering areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context.

⁶ Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Investment Advisers Act Release No. IA-4888 (April 18, 2018) (“Form CRS Proposal”).

⁷ This Release is intended to highlight the principles relevant to an adviser’s fiduciary duty. It is not, however, intended to be the exclusive resource for understanding these principles.

⁸ The Commission recognizes that many advisers provide impersonal investment advice. *See, e.g.*, Advisers Act rule 203A-3 (defining “impersonal investment advice” in the context of defining “investment adviser representative” as “investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts”). This Release does not address the extent to which the Advisers Act applies to different types of impersonal investment advice.

⁹ Regulation Best Interest Proposal, *supra* note 5. In addition to the obligations proposed in Regulation Best Interest, broker-dealers have a variety of existing specific obligations, including, among others, suitability, best execution, and fair and reasonable compensation. *See, e.g., Hanly v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969) (“A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents that he has an adequate and reasonable basis for the opinions he renders.”); and FINRA rules 2111 (Suitability), 5310 (Best Execution and Interpositioning), and 2121 (Fair Prices and Commissions)).

II. INVESTMENT ADVISERS' FIDUCIARY DUTY

The Advisers Act establishes a federal fiduciary standard for investment advisers.¹⁰ This fiduciary standard is based on equitable common law principles and is fundamental to advisers' relationships with their clients under the Advisers Act.¹¹ The fiduciary duty to which advisers are subject is not specifically defined in the Advisers Act or in Commission rules, but reflects a Congressional recognition "of the delicate fiduciary nature of an investment advisory relationship" as well as a Congressional intent to "eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested."¹² An adviser's fiduciary duty is imposed under the Advisers Act in recognition of the nature of the relationship between an investment adviser and a client and the desire "so far as is presently practicable to eliminate the abuses" that led to the enactment of the Advisers Act.¹³ It is made enforceable by the antifraud provisions of the

¹⁰ *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) ("Transamerica Mortgage v. Lewis") ("§ 206 establishes federal fiduciary standards to govern the conduct of investment advisers.") (quotation marks omitted); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 471, n.11 (1977) (in discussing *SEC v. Capital Gains*, stating that the Supreme Court's reference to fraud in the "equitable" sense of the term was "premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers"); *SEC v. Capital Gains*, *supra* note 2; Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) ("Investment Advisers Act Release 3060") ("Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own," citing Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) ("Investment Advisers Act Release 2106")).

¹¹ *See SEC v. Capital Gains*, *supra* note 2 (discussing the history of the Advisers Act, and how equitable principles influenced the common law of fraud and changed the suits brought against a fiduciary, "which Congress recognized the investment adviser to be").

¹² *See SEC v. Capital Gains*, *supra* note 2.

¹³ *See SEC v. Capital Gains*, *supra* note 2 ("The Advisers Act thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested." and also noting that the "declaration of policy" in the original bill, which became the Advisers Act, declared that "the national public interest and the interest of investors are adversely affected when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients. It [sic] is hereby declared that the policy and purposes of this title, in

Advisers Act.¹⁴

An investment adviser’s fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. Several commenters responding to Chairman Clayton’s June 2017 request for public input¹⁵ on the standards of conduct for investment advisers and broker-dealers acknowledged these duties.¹⁶ This fiduciary duty requires an adviser “to adopt the principal’s goals, objectives, or ends.”¹⁷ This means the adviser must, at all times, serve the best interest of its clients and not subordinate its clients’ interest to its own.¹⁸ The federal fiduciary duty is

accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section” (citing S. 3580, 76th Cong., 3d Sess., § 202 and Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong. 2d Sess., 1, at 28). *See also* In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948) (“Arleen Hughes”) (discussing the relationship of trust and confidence between the client and a dual registrant and stating that the registrant was a fiduciary and subject to liability under the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act).

¹⁴ SEC v. Capital Gains, *supra* note 2; Transamerica Mortgage v. Lewis, *supra* note 10 (“[T]he Act’s legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.”).

¹⁵ Public Comments from Retail Investors and Other Interested Parties on Standards of Conduct for Investment Advisers and Broker-Dealers, Chairman Jay Clayton (June 1, 2017), available at <https://www.sec.gov/news/public-statement/statement-chairman-clayton-2017-05-31> (“Chairman Clayton’s Request for Public Input”).

¹⁶ *See, e.g.*, Comment letter of the Investment Adviser Association (Aug. 31, 2017) (“IAA Letter”) (“The well-established fiduciary duty under the Advisers Act, which incorporates both a duty of loyalty and a duty of care, has been applied consistently over the years by courts and the SEC.”); Comment letter of the Consumer Federation of America (Sept. 14, 2017) (“an adviser’s fiduciary obligation ‘divides neatly into the duty of loyalty and the duty of care.’ The duty of loyalty is designed to protect against ‘malfeasance,’ or wrongdoing, on the part of the adviser, while the duty of care is designed to protect against ‘nonfeasance,’ such as neglect.”).

¹⁷ Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 Buffalo Law Review 99 (2008). *See also* Restatement (Third) of Agency, §2.02 Scope of Actual Authority (2006) (describing a fiduciary’s authority in terms of the fiduciary’s reasonable understanding of the principal’s manifestations and objectives).

¹⁸ Investment Advisers Act Release 3060, *supra* footnote 10 (adopting amendments to Form ADV and stating that “under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients’ interests to its own,” citing Investment Advisers Act Release 2106 *supra* note 10); SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008) (“Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors.”); SEC v. Moran, 944 F. Supp. 286 (S.D.N.Y. 1996) (“Investment advisers are entrusted with the responsibility and duty to act in the best interest of their clients.”).

imposed through the antifraud provisions of the Advisers Act.¹⁹ The duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship through contract when the client receives full and fair disclosure and provides informed consent.²⁰ Although the ability to tailor the terms means that the application of the fiduciary duty will vary with the terms of the relationship, the relationship in all cases remains that of a fiduciary to a client. In other words, the investment adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty.²¹ We discuss our views²² on an

¹⁹ See *supra* note 14.

²⁰ See *infra* note 40 and accompanying text for a discussion of informed consent.

²¹ As an adviser's federal fiduciary obligations are enforceable through section 206 of the Act, we would view a waiver of enforcement of section 206 as implicating section 215(a) of the Act, which provides that "any condition, stipulation or provision binding any person to waive compliance with any provision of this title. . . shall be void." Some commenters on Chairman Clayton's Request for Public Input and other Commission requests for comment also stated that an adviser's fiduciary duty could not be disclosed away. See, e.g., IAA Letter *supra* note 16 ("While disclosure of conflicts is crucial, it cannot take the place of the overarching duty of loyalty. In other words, an adviser is still first and foremost bound by its duty to act in its client's best interest and disclosure does not relieve an adviser of this duty."); Comment letter of AARP (Sept. 6, 2017) ("Disclosure and consent alone do not meet the fiduciary test."); Financial Planning Coalition Letter (July 5, 2013) responding to SEC Request for Data and Other Information, Duties of Brokers, Dealers, and Investment Advisers, Exchange Act Release No. 69013 (Mar. 1, 2013) ("Financial Planning Coalition 2013 Letter") ("[D]isclosure alone is not sufficient to discharge an investment adviser's fiduciary duty; rather, the key issue is whether the transaction is in the best interest of the client.") (internal citations omitted). See also Restatement (Third) of Agency, § 8.06 Principal's Consent (2006) ("The law applicable to relationships of agency as defined in § 1.01 imposes mandatory limits on the circumstances under which an agent may be empowered to take disloyal action. These limits serve protective and cautionary purposes. Thus, an agreement that contains general or broad language purporting to release an agent in advance from the agent's general fiduciary obligation to the principal is not likely to be enforceable. This is because a broadly sweeping release of an agent's fiduciary duty may not reflect an adequately informed judgment on the part of the principal; if effective, the release would expose the principal to the risk that the agent will exploit the agent's position in ways not foreseeable by the principal at the time the principal agreed to the release. In contrast, when a principal consents to specific transactions or to specified types of conduct by the agent, the principal has a focused opportunity to assess risks that are more readily identifiable."); Tamar Frankel, Arthur Laby & Ann Schwing, *The Regulation of Money Managers*, (updated 2017) ("The Regulation of Money Managers") ("Disclosure may, but will not always, cure the fraud, since a fiduciary owes a duty to deal fairly with clients.").

²² 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.

investment adviser's fiduciary duty in more detail below.²³

A. Duty of Care

As fiduciaries, investment advisers owe their clients a duty of care.²⁴ The Commission has discussed the duty of care and its components in a number of contexts.²⁵ The duty of care includes, among other things: (i) the duty to act and 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.

i. Duty to Provide Advice that is in the Client's Best Interest

We have addressed an adviser's duty of care in the context of the provision of personalized investment advice. In this context, the duty of care includes a duty to make a reasonable inquiry into a client's financial situation, level of financial sophistication, investment

²³ The interpretations discussed in this Release also apply to automated advisers, which are often colloquially referred to as "robo-advisers." Robo-advisers, like all SEC-registered investment advisers, are subject to all of the requirements of the Advisers Act, including the requirement that they provide advice consistent with the fiduciary duty they owe to their clients. The staff of the Commission has issued guidance regarding how robo-advisers can meet their obligations under the Advisers Act, given the unique challenges and opportunities presented by their business models. *See Division of Investment Management, SEC, Staff Guidance on Robo Advisers*, (February 2017), available at <https://www.sec.gov/investment/im-guidance-2017-02.pdf>.

²⁴ *See* Investment Advisers Act Release No. 2106, *supra* note 10 (stating that under the Advisers Act, "an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting," which is the subject of the release, and citing *SEC v. Capital Gains* *supra* note 2, to support this point). *See also* Restatement (Third) of Agency, § 8.08 (discussing the duty of care that an agent owes its principal as a matter of common law); *The Regulation of Money Managers*, *supra* note 21 ("Advice can be divided into three stages. The first determines the needs of the particular client. The second determines the portfolio strategy that would lead to meeting the client's needs. The third relates to the choice of securities that the portfolio would contain. The duty of care relates to each of the stages and depends on the depth or extent of the advisers' obligation towards their clients.").

²⁵ *See, e.g.*, Suitability of Investment Advice Provided by Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406 (Mar. 16, 1994) ("Investment Advisers Act Release 1406") (stating that advisers have a duty of care and discussing advisers' suitability obligations); Securities; Brokerage and Research Services, Exchange Act Release No. 23170 (Apr. 23, 1986) ("Exchange Act Release 23170") ("an adviser, as a fiduciary, owes its clients a duty of obtaining the best execution on securities transactions."). We highlight certain contexts in which the Commission has addressed the duty of care but we note that there are others; for example, voting proxies when an adviser undertakes to do so. Investment Advisers Act Release 2106, *supra* note 10.

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.²⁶

An adviser must, before providing any personalized investment advice and as appropriate thereafter, make a reasonable inquiry into the client’s investment profile. The nature and extent of the inquiry turn on what is reasonable under the circumstances, including the nature and extent of the agreed-upon advisory services, the nature and complexity of the anticipated investment advice, and the investment profile of the client. For example, to formulate a comprehensive financial plan for a client, an adviser might obtain a range of personal and financial information about the client, including current income, investments, assets and debts, marital status, insurance policies, and financial goals.²⁷

An adviser must update a client’s investment profile in order to adjust its advice to reflect any changed circumstances.²⁸ The frequency with which the adviser must update the information in order to consider changes to any advice the adviser provides would turn on many factors, including whether the adviser is aware of events that have occurred that could render inaccurate or incomplete the investment profile on which it currently bases its advice. For

²⁶ In 1994, the Commission proposed a rule that would make express the fiduciary obligation of investment advisers to make only suitable recommendations to a client. Investment Advisers Act Release 1406, *supra* note 25. Although never adopted, the rule was designed, among other things, to reflect the Commission’s interpretation of an adviser’s existing suitability obligation under the Advisers Act. We believe that this obligation, when combined with an adviser’s fiduciary duty to act in the best interest of its client, requires an adviser to provide investment advice that is suitable for *and in the best interest of* its client.

²⁷ Investment Advisers Act Release 1406, *supra* note 25. After making a reasonable inquiry into the client’s investment profile, it generally would be reasonable for an adviser to rely on information provided by the client (or the client’s agent) regarding the client’s financial circumstances, and an adviser should not be held to have given advice not in its client’s best interest if it is later shown that the client had misled the adviser.

²⁸ We note that this would not be done for a one-time financial plan or other investment advice that is not provided on an ongoing basis. *See also infra* note 37.

example, a change in the relevant tax law or knowledge that the client has retired or experienced a change in marital status might trigger an obligation to make a new inquiry.

An investment adviser must also have a reasonable belief that the personalized advice is suitable for and in the best interest of the client based on the client's investment profile. A reasonable belief would involve considering, for example, 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.²⁹ Whether the advice is in a client's best interest must be evaluated in the context of the portfolio that the adviser manages for the client and the client's investment profile. For example, when an adviser is advising a 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 in the client's portfolio, whereas investing in certain directionally speculative derivatives on their own may not. For that same client, investing in a particular security on margin may not be in the client's best interest, even if investing in that same security may be in the client's best interest. When advising a financially sophisticated investor with a high risk tolerance, however, it may be consistent with the adviser's duties to recommend investing in such directionally speculative derivatives or investing in securities on margin.

The cost (including fees and compensation) associated with investment advice would generally be one of many important factors—such as the investment product's or strategy's investment objectives, characteristics (including any special or unusual features), liquidity, risks

²⁹ We note that Item 8 of Part 2A of Form ADV requires an investment adviser to describe its methods of analysis and investment strategies and disclose that investing in securities involves risk of loss which clients should be prepared to bear. This item also requires that an adviser explain the material risks involved for each significant investment strategy or method of analysis it uses and particular type of security it recommends, with more detail if those risks are significant or unusual.

and potential benefits, volatility and likely performance in a variety of market and economic conditions—to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client. Accordingly, the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy. We believe that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance. For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client’s return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict.³⁰ Furthermore, an adviser would not satisfy its fiduciary duty to provide advice that is in the client’s best interest by simply advising its client to invest in the least expensive or least remunerative investment product or strategy without any further analysis of other factors in the context of the portfolio that the adviser manages for the client and the client’s investment profile. For example, it might be consistent with an adviser’s fiduciary duty to advise a client with a high risk tolerance and significant investment experience to invest in a private equity fund with relatively high fees if other factors about the fund, such as its diversification and potential performance benefits, cause it to be in the client’s best interest. We believe that a reasonable belief that investment advice is in the best interest of a client also

³⁰ See *infra* notes 48 – 52 and accompanying text (discussing an adviser’s duties related to disclosure and consent).

requires that an adviser conduct a reasonable investigation into the investment sufficient to not base its advice on materially inaccurate or incomplete information.³¹ We have brought enforcement actions where an investment adviser did not independently or reasonably investigate securities before recommending them to clients.³² This obligation to provide advice that is suitable and in the best interest applies not just to potential investments, but to all advice the investment adviser provides to clients, including advice about an investment strategy or engaging a sub-adviser and advice about whether to rollover a retirement account so that the investment adviser manages that account.

ii. Duty to Seek Best Execution

We have addressed an investment adviser's duty of care in the context of trade execution where the adviser has the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts). We have said that, in this context, an adviser has the duty to seek best execution of a client's transactions.³³ In meeting this obligation, 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. An adviser fulfills this duty by executing securities transactions on behalf of a client with the goal of

³¹ See, e.g., Concept Release on the U.S. Proxy System, Investment Advisers Act Release No. 3052 (July 14, 2010) (stating "as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information").

³² See *In the Matter of Larry C. Grossman*, Investment Advisers Act Release No. 4543 (Sept. 30, 2016) (Commission opinion) (imposing liability on a principal of a registered investment adviser for recommending offshore private investment funds to clients without a reasonable independent basis for his advice).

³³ See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54165 (July 18, 2006) (stating that investment advisers have "best execution obligations"); Investment Advisers Act Release 3060, *supra* note 10 (discussing an adviser's best execution obligations in the context of directed brokerage arrangements and disclosure of soft dollar practices). See also Advisers Act rule 206(3)-2(c) (referring to adviser's duty of best execution of client transactions).

maximizing value for the client under the particular circumstances occurring at the time of the transaction. As noted below, maximizing value can encompass more than just minimizing cost. When seeking best execution, an adviser should 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.³⁴ In other words, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution. Further, an investment adviser should “periodically and systematically” evaluate the execution it is receiving for clients.³⁵

iii. Duty to Act and to Provide Advice and Monitoring over the Course of the Relationship

An investment adviser’s duty of care also encompasses the duty to provide advice and monitoring over the course of a relationship with a client.³⁶ An 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

³⁴ Exchange Act Release 23170, *supra* note 25.

³⁵ *Id.* The Advisers Act does not prohibit advisers from using an affiliated broker to execute client trades. However, the adviser’s use of such an affiliate involves a conflict of interest that must be fully and fairly disclosed and the client must provide informed consent to the conflict.

³⁶ *See* SEC v. Capital Gains, *supra* note 2 (describing advisers’ “basic function” as “furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments” (quoting Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong. 2d Sess., 1, at 28)). *Cf.* Barbara Black, *Brokers and Advisers-What’s in a Name?*, 32 Fordham Journal of Corporate and Financial Law XI (2005) (“[W]here the investment adviser’s duties include management of the account, [the adviser] is under an obligation to monitor the performance of the account and to make appropriate changes in the portfolio.”); Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 Villanova Law Review 701, at 728 (2010) (“Laby Villanova Article”) (“If an adviser has agreed to provide continuous supervisory services, the scope of the adviser’s fiduciary duty entails a continuous, ongoing duty to supervise the client’s account, regardless of whether any trading occurs. This feature of the adviser’s duty, even in a non-discretionary account, contrasts sharply with the duty of a broker administering a non-discretionary account, where no duty to monitor is required.”) (internal citations omitted).

best interest of the client and consistent with the scope of advisory services agreed upon between the investment adviser and the client. The duty to provide advice and monitoring is particularly important for an adviser that has an ongoing relationship with a client (for example, a relationship where the adviser is compensated with a periodic asset-based fee or an adviser with discretionary authority over client assets). Conversely, the steps needed to fulfill this duty may be relatively circumscribed for the adviser and client that have agreed to a relationship of limited duration via contract (for example, a financial planning relationship where the adviser is compensated with a fixed, one-time fee commensurate with the discrete, limited-duration nature of the advice provided).³⁷ An adviser's duty to monitor extends to all personalized advice it provides the client, including an evaluation of whether a client's account or program type (for example, a wrap account) continues to be in the client's best interest.

B. Duty of Loyalty

The duty of loyalty requires an investment adviser to put its client's interests first. An investment adviser must not favor its own interests over those of a client or unfairly favor one client over another.³⁸ In seeking to meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.³⁹ In addition, an

³⁷ See Laby Villanova Article, *supra* note 36, at 728 (2010) (stating that the scope of an adviser's activity can be altered by contract and that an adviser's fiduciary duty would be commensurate with the scope of the relationship).

³⁸ See Investment Advisers Act Release 3060 ("Under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own," citing Investment Advisers Act Release 2106 *supra* note 9). See also Staff of the U.S. Securities and Exchange Commission, *Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011), available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf> ("913 Study").

³⁹ Investment Advisers Act Release 3060, *supra* note 6 ("as a fiduciary, an adviser has an ongoing obligation to inform its clients of any material information that could affect the advisory relationship"). See also General Instruction 3 to Part 2 of Form ADV ("Under federal and state law, you are a fiduciary and must make full disclosure to your *clients* of all material facts relating to the advisory relationship.").

adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. The disclosure should be sufficiently specific so that a client is able to decide whether to provide informed consent to the conflict of interest.⁴⁰ We discuss each of these aspects of the duty of loyalty below.

Because an adviser must serve the best interests of its clients, it has an obligation not to subordinate its clients' interests to its own. For example, an adviser cannot favor its own interests over those of a client, whether by favoring its own accounts or by favoring certain client accounts that pay higher fee rates to the adviser over other client accounts.⁴¹ Accordingly, the duty of loyalty includes a duty not to treat some clients favorably at the expense of other clients. Thus, we believe that in allocating investment opportunities among eligible clients, an adviser

⁴⁰ Arleen Hughes, *supra* note 13, at 4 and 8 (stating, “[s]ince loyalty to his trust is the first duty which a fiduciary owes to his principal, it is the general rule that a fiduciary must not put himself into a position where his own interests may come in conflict with those of his principal. To prevent any conflict and the possible subordination of this duty to act solely for the benefit of his principal, a fiduciary at common law is forbidden to deal as an adverse party with his principal. An exception is made, however, where the principal gives his informed consent to such dealings,” and adding that, “[r]egistrant has an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent.”). *See also Hughes v. Securities and Exchange Commission*, 174 F.2d 969 (1949) (affirming the SEC decision in Arleen Hughes).

See also General Instruction 3 to Part 2 of Form ADV (stating that an adviser's disclosure obligation “requires that [the adviser] provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest [the adviser has] and the business practices in which [the adviser] engage[s], and can give informed consent to such conflicts or practices or reject them”); Investment Advisers Act Release 3060, *supra* note 10 (same); Restatement (Third) of Agency §8.06 (“Conduct by an agent that would otherwise constitute a breach of duty as stated in §§ 8.01, 8.02, 8.03, 8.04, and 8.05 [referencing the fiduciary duty] does not constitute a breach of duty if the principal consents to the conduct, provided that (a) in obtaining the principal's consent, the agent (i) acts in good faith, (ii) discloses all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal; and (b) the principal's consent concerns either a specific act or transaction, or acts or transactions of a specified type that could reasonably be expected to occur in the ordinary course of the agency relationship”)

⁴¹ The Commission has brought numerous enforcement actions against advisers that unfairly allocated trades to their own accounts and allocated less favorable or unprofitable trades to their clients' accounts. *See, e.g., SEC v. Strategic Capital Management, LLC and Michael J. Breton*, Litigation Release No. 23867 (June 23, 2017) (partial settlement) (adviser placed trades through a master brokerage account and then allocated profitable trades to adviser's account while placing unprofitable trades into the client accounts.).

must treat all clients fairly.⁴² This does not mean that an adviser must have a *pro rata* allocation policy, that the adviser's allocation policies cannot reflect the differences in clients' objectives or investment profiles, or that the adviser cannot exercise judgment in allocating investment opportunities among eligible clients. Rather, it means that an adviser's allocation policies must be fair and, if they present a conflict, the adviser must fully and fairly disclose the conflict such that a client can provide informed consent.

An adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure to its clients of all material conflicts of interest that could affect the advisory relationship.⁴³ Disclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act.⁴⁴ Any disclosure must be clear and detailed enough for a client to make a reasonably informed decision to consent to such conflicts and practices or reject them.⁴⁵ An adviser must provide the client with sufficiently specific facts so that the client is able to understand the adviser's conflicts of interest and

⁴² See also Barry Barbash and Jai Massari, *The Investment Advisers Act of 1940; Regulation by Accretion*, 39 Rutgers Law Journal 627 (2008) (stating that under section 206 of the Advisers Act and traditional notions of fiduciary and agency law an adviser must not give preferential treatment to some clients or systematically exclude eligible clients from participating in specific opportunities without providing the clients with appropriate disclosure regarding the treatment).

⁴³ See *SEC v. Capital Gains*, *supra* note 2 (advisers must fully disclose all material conflicts, citing Congressional intent “to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested”). See also Investment Advisers Act Release 3060, *supra* note 9.

⁴⁴ See *SEC v. Capital Gains*, *supra* note 2 (in discussing the legislative history of the Advisers Act, citing ethical standards of one of the leading investment counsel associations, which provided that an investment counsel should remain “as free as humanly possible from the subtle influence of prejudice, conscious or unconscious” and “avoid any affiliation, or any act which subjects his position to challenge in this respect” and stating that one of the policy purposes of the Advisers Act is “to mitigate and, so far as is presently practicable to eliminate the abuses” that formed the basis of the Advisers Act). Separate and apart from potential liability under the antifraud provisions of the Advisers Act enforceable by the Commission for breaches of fiduciary duty in the absence of full and fair disclosure, investment advisers may also wish to consider their potential liability to clients under state common law, which may vary from state to state.

⁴⁵ See Arlene Hughes, *supra* at 13 (in finding that registrant had not obtained informed consent, citing to testimony indicating that “some clients had no understanding at all of the nature and significance” of the disclosure).

business practices well enough to make an informed decision.⁴⁶ For example, an adviser disclosing that it “may” have a conflict is not adequate disclosure when the conflict actually exists.⁴⁷ A client’s informed consent can be either explicit or, depending on the facts and circumstances, implicit. We believe, however, that it would not be consistent with an adviser’s fiduciary duty to infer or accept client consent to a conflict where either (i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict, or (ii) the material facts concerning the conflict could not be fully and fairly disclosed.⁴⁸ For example, in some cases, conflicts may be of a nature and extent that it would be difficult to provide disclosure that adequately conveys the material facts or the nature, magnitude and potential effect of the conflict necessary to obtain informed consent and satisfy an adviser’s fiduciary duty. In other cases, disclosure may not be specific enough for clients to understand whether and how the conflict will affect the advice they receive. With some complex or

⁴⁶ See General Instruction 3 to Part 2 of Form ADV. Cf. Arleen Hughes, *supra* note 13 (Hughes acted simultaneously in the dual capacity of investment adviser and of broker and dealer and conceded having a fiduciary duty. In describing the fiduciary duty and her potential liability under the antifraud provisions of the Securities Act and the Exchange Act, the Commission stated she had “an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent.”).

⁴⁷ We have brought enforcement actions in such cases. See, e.g., In the Matter of The Robare Group, Ltd., et al., Investment Advisers Act Release No. 4566 (Nov. 7, 2016) (Commission Opinion) (appeal docketed) (finding, among other things, that adviser’s disclosure was inadequate because it stated that the adviser *may* receive compensation from a broker as a result of the facilitation of transactions on client’s behalf through such broker-dealer and that these arrangements *may* create a conflict of interest when adviser *was*, in fact, receiving payments from the broker and *had* such a conflict of interest).

⁴⁸ See Arleen Hughes, *supra* note 13 (“Registrant cannot satisfy this duty by executing an agreement with her clients which the record shows some clients do not understand and which, in any event, does not contain the essential facts which she must communicate.”) Some commenters on Commission requests for comment agreed that full and fair disclosure and informed consent are important components of an adviser’s fiduciary duty. See, e.g., Financial Planning Coalition 2013 Letter, *supra* note 21 (“[C]onsent is only informed if the customer has the ability fully to understand and to evaluate the information. Many complex products ... are appropriate only for sophisticated and experienced investors. It is not sufficient for a fiduciary to make disclosure of potential conflicts of interest with respect to such products. The fiduciary must make a reasonable judgment that the customer is fully able to understand and to evaluate the product and the potential conflicts of interest that it presents – and then the fiduciary must make a judgment that the product is in the best interests of the customer.”).

extensive conflicts, it may be difficult to provide disclosure that is sufficiently specific, but also understandable, to the adviser's clients. In all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed.

Full and fair disclosure of all material facts that could affect an advisory relationship, including all material conflicts of interest between the adviser and the client, can help clients and prospective clients in evaluating and selecting investment advisers. Accordingly, we require advisers to deliver to their clients a "brochure," under Part 2A of Form ADV, which sets out minimum disclosure requirements, including disclosure of certain conflicts.⁴⁹ Investment advisers are required to deliver the brochure to a prospective client at or before entering into a contract so that the prospective client can use the information contained in the brochure to decide whether or not to enter into the advisory relationship.⁵⁰ In a concurrent release, we are proposing to require all investment advisers to deliver to retail investors before or at the time the adviser enters into an investment advisory agreement a relationship summary which would include a summary of certain conflicts of interest.⁵¹

⁴⁹ Investment Advisers Act Release 3060, *supra* note 10; General Instruction 3 to Part 2 of Form ADV ("Under federal and state law, you are a fiduciary and must make full disclosure to your clients of all material facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. This obligation requires that you provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest you have and the business practices in which you engage, and can give informed consent to such conflicts or practices or reject them.").

⁵⁰ Investment Advisers Act rule 204-3. Investment Advisers Act Release 3060, *supra* note 10 (adopting amendments to Form ADV and stating that "A client may use this disclosure to select his or her own adviser and evaluate the adviser's business practices and conflicts on an ongoing basis. As a result, the disclosure clients and prospective clients receive is critical to their ability to make an informed decision about whether to engage an adviser and, having engaged the adviser, to manage that relationship.").

⁵¹ Form CRS Proposal, *supra* note 6.

C. Request for Comment

The Commission requests comment on our proposed interpretation regarding certain aspects of the fiduciary duty under section 206 of the Advisers Act.

- Does the Commission’s proposed interpretation offer sufficient guidance with respect to the fiduciary duty under section 206 of the Advisers Act?
- Are there any significant issues related to an adviser’s fiduciary duty that the proposed interpretation has not addressed?
- Would it be beneficial for investors, advisers or broker-dealers for the Commission to codify any portion of our proposed interpretation of the fiduciary duty under section 206 of the Advisers Act?

III. ECONOMIC CONSIDERATIONS

The Commission is sensitive to the potential economic effects of the proposed interpretation provided above.⁵² In this section we discuss how the proposed Commission interpretation may benefit investors and reduce agency problems by reaffirming and clarifying the fiduciary duty an investment adviser owes to its clients. We also discuss some potential broader economic effects on the market for investment advice.

A. Background

The Commission’s interpretation of the standard of conduct for investment advisers under the Advisers Act set forth in this Release would affect investment advisers and their associated persons as well as the clients of those investment advisers, and the market for

⁵² The Commission, where possible, has sought to quantify the economic impacts expected to result from the proposed interpretations. However, as discussed more specifically below, the Commission is unable to quantify certain of the economic effects because it lacks information necessary to provide reasonable estimates.

financial advice more broadly.⁵³ There are 12,659 investment advisers registered with the Commission with over \$72 trillion in assets under management as well as 17,635 investment advisers registered with states and 3,587 investment advisers who submit Form ADV as exempt reporting advisers.⁵⁴ As of December 2017, there are approximately 36 million client accounts advised by SEC-registered investment advisers.

These investment advisers currently incur ongoing costs related to their compliance with their legal and regulatory obligations, including costs related to their understanding of the standard of conduct. We believe, based on the Commission's experience, that the interpretations we are setting forth in this Release are generally consistent with investment advisers' current understanding of the practices necessary to comply with their fiduciary duty under the Advisers Act; however, we recognize that there may be certain current investment advisers who have interpreted their fiduciary duty to require something less, or something more, than the Commission's interpretation. We lack data to identify which investment advisers currently understand the practices necessary to comply with their fiduciary duty to be different from the standard of conduct in the Commission's interpretation. Based on our experience, however, we generally believe that it is not a significant portion of the market.

B. Economic Impacts

Based on our experience as the long-standing regulator of the investment adviser industry, the Commission's interpretation of the fiduciary duty under section 206 of the Advisers

⁵³ See Form CRS Proposal, *supra* note 6, at Section IV.A (discussing the market for financial advice generally).

⁵⁴ See Form CRS Proposal, *supra* note 6, at Section IV.A.1.b (discussing SEC-registered investment advisers). Note, however, that because we are interpreting advisers' fiduciary duties under section 206 of the Advisers Act, this interpretation would be applicable to both SEC- and state-registered investment advisers, as well as other investment advisers that are exempt from registration or subject to a prohibition on registration under the Advisers Act.

Act described in this Release generally reaffirms the current practices of investment advisers. Therefore, we expect there to be no significant economic impacts from the interpretation. We do acknowledge, however, to the extent certain investment advisers currently understand the practices necessary to comply with their fiduciary duty to be different from those discussed in this interpretation, there could be some potential economic effects, which we discuss below.

Clients of investment advisers

The typical relationship between an investment adviser and a client is a principal-agent relationship, where the principal (the client) hires an agent (the investment adviser) to perform some service (investment advisory services) on the client's behalf.⁵⁵ Because investors and investment advisers are likely to have different preferences and goals, the investment adviser relationship is subject to agency problems: that is, investment advisers may take actions that increase their well-being at the expense of investors, thereby imposing agency costs on investors.⁵⁶ A fiduciary duty, such as the duty investment advisers owe their clients, can mitigate these agency problems and reduce agency costs by deterring agents from taking actions that expose them to legal liability.⁵⁷

To the extent the Commission's interpretation of investment adviser fiduciary duty would cause a change in behavior of those investment advisers, if any, who currently interpret their fiduciary duty to require something different from the Commission's interpretation, we expect a

⁵⁵ See, e.g., James A. Brickley, Clifford W. Smith, Jr., Jerold L. Zimmerman, *Managerial Economics and Organizational Architecture* (2004), at 265 ("An agency relationship consists of an agreement under which one party, the principal, engages another party, the agent, to perform some service on the principal's behalf."). See also Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, *Journal of Financial Economics*, Vol. 3, 305-360 (1976).

⁵⁶ See, e.g., Jensen and Meckling, *supra* note 55. See also the discussion on agency problems in the market for investment advice in Section IV.B. of the Regulation Best Interest Proposal, *supra* note 5.

⁵⁷ See, e.g., Frank H. Easterbrook and Daniel R. Fischel, *Contract and Fiduciary Duty*, *Journal of Law & Economics*, Vol. 36, 425-46 (1993).

potential reduction in agency problems and, consequently, a reduction of agency costs to the client. The extent to which agency costs would be reduced is difficult to assess given that we are unable to ascertain whether any investment advisers currently interpret their fiduciary duty to be something different from the Commission's interpretation, and consequently we are not able to estimate the agency costs these advisers, if any, currently impose on investors. However, we believe that there may be potential benefits for clients of those investment advisers, if any, to the extent the Commission's interpretation is effective at strengthening investment advisers' understanding of their obligations to their clients. For example, to the extent that the Commission's interpretation enhances the understanding of any investment advisers of their duty of care, it may potentially raise the quality of investment advice given and that advice's fit with a client's individual profile and preferences or lead to increased compliance with the duty to provide advice and monitoring over the course of the relationship.

Additionally, to the extent the Commission's interpretation enhances the understanding of any investment advisers of their duty of loyalty it may potentially benefit the clients of those investment advisers. Specifically, to the extent this leads to a higher quality of disclosures about conflicts for clients of some investment advisers, the nature and extent of such conflict disclosures would help investors better assess the quality of the investment advice they receive, therefore providing an important benefit to investors.

Further, to the extent that the interpretation causes some investment advisers to properly identify circumstances in which disclosure alone cannot cure a conflict of interest, the proposed interpretation may lead those investment advisers to take additional steps to mitigate or eliminate the conflict. The interpretation may also cause some investment advisers to conclude in some circumstances that even if disclosure would be enough to meet their fiduciary duty, such

disclosure would have to be so expansive or complex that they instead voluntarily mitigate or eliminate the conflicts of interest. Thus, to the extent the Commission's interpretation would cause investment advisers to better understand their obligations as part of their fiduciary duty and therefore to make changes to their business practices in ways that reduce the likelihood of conflicted advice or the magnitude of the conflicts, it may ameliorate the agency conflict between investment advisers and their clients and, in turn, may improve the quality of advice that the clients receive. This less-conflicted advice may therefore produce higher overall returns for clients and increase the efficiency of portfolio allocation. However, as discussed above, we would generally expect these effects to be minimal. Finally, this interpretation would also benefit clients of investment advisers to the extent it assists the Commission in its oversight of investment advisers' compliance with their regulatory obligations.

Investment advisers and the market for investment advice

In general, we expect the Commission's interpretation of an investment adviser's fiduciary duty would affirm investment advisers' understanding of the obligations they owe their clients, reduce uncertainty for advisers, and facilitate their compliance. Furthermore, by addressing in one release certain aspects of the fiduciary duty that an investment adviser owes to its clients, the Commission's interpretation could reduce the costs associated with comprehensively assessing their compliance obligations. We acknowledge that, as with other circumstances in which the Commission speaks to the legal obligations of regulated entities, affected firms, including those whose practices are consistent with the Commission's interpretation, incur costs to evaluate the Commission's interpretation and assess its applicability to them. Moreover, as discussed above, there may be certain investment advisers who currently understand the practices necessary to comply with their fiduciary duty to be different from the

standard of conduct in the Commission’s interpretation. Those investment advisers if any, would experience an increase in their compliance costs as they change their systems, processes and behavior, and train their supervised persons, to align with the Commission’s interpretation.

Moreover, to the extent any investment advisers that understood their fiduciary obligation to be different from the Commission’s interpretation change their behavior to align with this interpretation, there could potentially also be some economic effects on the market for investment advice. For example, any improved compliance may not only reduce agency costs in current investment advisory relationships and increase the value of those relationships to current clients, it may also increase trust in the market for investment advice among all investors, which may result in more investors seeking advice from investment advisers. This may, in turn, benefit investors by improving the efficiency of their portfolio allocation. To the extent it is costly or difficult, at least in the short term, to expand the supply of investment advisory services to meet an increase in demand, any such new demand for investment adviser services could potentially put some upward price pressure on fees. At the same time, however, if any such new demand increases the overall profitability of investment advisory services, then we expect it would encourage entry by new investment advisers – or hiring of new representatives, by current investment advisers – such that competition would increase over time. Indeed, we recognize that the recent growth in the investment adviser segment of the market, both in terms of firms and number of representatives,⁵⁸ may suggest that the costs of expanding the supply of investment advisory services are currently relatively low.

Additionally, we acknowledge that to the extent certain investment advisers recognize, due to the Commission’s interpretation, that their obligations to clients are stricter than how they

⁵⁸ See Form CRS Proposal, *supra* note 6, at Section IV.A.1.d.

currently interpret their fiduciary duty, it could potentially affect competition. Specifically, the Commission's interpretation of certain aspects of the standard of conduct for investment advisers may result in additional compliance costs to meet their fiduciary obligation under the Commission's interpretation. This increase in compliance costs, in turn, may discourage competition for client segments that generate lower revenues, such as clients with relatively low levels of financial assets, which could reduce the supply of investment adviser services and raise fees for these client segments. However, the investment advisers who already are complying with the understanding of their fiduciary duty reflected in the Commission's interpretation, and may therefore currently have a comparative cost disadvantage, could potentially find it more profitable to compete for the customers of those investment advisers who would face higher compliance costs as a result of the proposed interpretation, which would mitigate negative effects on the supply of investment adviser services. Furthermore, as noted above, there has been a recent growth trend in the supply of investment advisory services, which is likely to mitigate any potential negative supply effects from the Commission's interpretation.⁵⁹

Finally, to the extent the proposed interpretation would cause some investment advisers to reassess their compliance with their disclosure obligations, it could lead to a reduction in the expected profitability of certain products associated with particularly conflicted advice for which

⁵⁹ Beyond having an effect on competition in the market for investment adviser services, it is possible that the Commission's interpretation could affect competition between investment advisers and other providers of financial advice, such as broker-dealers, banks, and insurance companies. This may be the case if certain investors base their choice between an investment adviser and another provider of financial advice, at least in part, on their perception of the standards of conduct each owes to their customers. To the extent that the Commission's interpretation increases investors' trust in investment advisers' overall compliance with their standard of conduct, certain of these investors may become more willing, to hire an investment adviser rather than one of their non-investment adviser competitors. As a result, investment advisers as a group may increase their competitive situation compared to that of other types of providers of financial advice. On the other hand, if the Commission's interpretation raises costs for investment advisers, they could become less competitive with other financial services providers.

compliance costs would increase following the reassessment.⁶⁰ As a result, the number of investment advisers willing to advise a client to make these investments may be reduced. A decline in the supply of investment adviser advice on these investments could potentially reduce the efficiency of portfolio allocation of those investors who might otherwise benefit from investment adviser advice on these investments.

IV. REQUEST FOR COMMENT REGARDING AREAS OF ENHANCED INVESTMENT ADVISER REGULATION

In 2011, the Commission issued the staff's 913 Study, pursuant to section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, in which the staff recognized several areas for potential harmonization of broker-dealer and investment adviser regulation.⁶¹ We have identified a few discrete areas where the current broker-dealer framework provides investor protections that may not have counterparts in the investment adviser context, and request comment on those areas. The Commission intends to consider these comments in connection with any future proposed rules or other proposed regulatory actions with respect to these matters.

⁶⁰ For example, such products could include highly complex, high cost products with risk and return characteristics that are hard to fully understand for retail investors or mutual funds or fund share classes that may pay higher compensation to investment advisers that are dual registrants, or that the investment adviser and its representatives may receive through payments to an affiliated broker-dealer or third party broker-dealer with which representatives of the investment adviser are associated.

⁶¹ The staff made two primary recommendations in the 913 Study. The first recommendation was that we engage in rulemaking to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. The second recommendation was that we consider harmonizing certain regulatory requirements of broker-dealers and investment advisers where such harmonization appears likely to enhance meaningful investor protection, taking into account the best elements of each regime. In the 913 Study, the areas the staff suggested the Commission consider for harmonization included, among others, licensing and continuing education requirements for persons associated with firms. The staff stated that the areas identified were not intended to be a comprehensive or exclusive listing of potential areas of harmonization. *See* 913 Study *supra* note 38.

A. Federal Licensing and Continuing Education

Associated persons of broker-dealers that effect securities transactions are required to be registered with the Financial Industry Regulatory Authority (“FINRA”),⁶² and must meet qualification requirements, which include passing a securities qualification exam and fulfilling continuing education requirements.⁶³ The federal securities laws do not require investment adviser representatives to become licensed or to meet qualification requirements, but most states impose registration, licensing, or qualification requirements on investment adviser representatives who have a place of business in the state, regardless of whether the investment adviser is registered with the Commission or the state.⁶⁴ These qualification requirements typically mandate that investment adviser representatives register and pass certain securities exams or hold certain designations (such as Chartered Financial Analyst credential).⁶⁵ The staff recommended in the 913 Study that the Commission consider requiring investment adviser representatives to be subject to federal continuing education and licensing requirements.⁶⁶

⁶² Generally, all registered broker-dealers that deal with the public must become members of FINRA, a registered national securities association, and may choose to become exchange members. *See* Exchange Act section 15(b)(8) and Exchange Act rule 15b9-1. FINRA is the sole national securities association registered with the SEC under section 15A of the Exchange Act.

⁶³ *See* NASD Rule 1021 (“Registration Requirements”); NASD Rule 1031 (“Registration Requirements”); NASD Rule 1041 (“Registration Requirements for Assistant Representatives”); FINRA Rule 1250 (“Continuing Education Requirements”).

⁶⁴ *See* 913 Study, *supra* note 38, at 86. *See also* Advisers Act rule 203A-3(a) (definition of “investment adviser representative”).

⁶⁵ *See* 913 Study, *supra* note 38, at 86-87, 138. The North American Securities Administrators Association (“NASAA”) is considering a potential model rule that would require that investment adviser representatives meet a continuing education requirement in order to maintain their state registrations. An internal survey of NASAA’s membership identified strong support for such a requirement along with significant regulatory need. NASAA is now conducting a nationwide survey of relevant stakeholders to get their input and views on such a requirement. For more information, see <http://www.nasaa.org/industry-resources/investment-advisers/nasaa-survey-regarding-continuing-education-for-investment-adviser-representatives/>.

⁶⁶ Several commenters, cited in the 913 Study, suggested that this was a gap that should be addressed. *See* 913 Study, *supra* note 38, at 138 (citing letters from AALU, Bank of America, FSI, Hartford, LPL, UBS, and Woodbury).

We request comment on whether there should be federal licensing and continuing education requirements for personnel of SEC-registered investment advisers. Such requirements could be designed to address minimum and ongoing competency requirements for the personnel of SEC-registered advisers.⁶⁷

- Should investment adviser representatives be subject to federal continuing education and licensing requirements?
- Which advisory personnel should be included in these requirements? For example, should persons whose functions are solely clerical or ministerial be excluded, similar to the exclusion in the FINRA rules regarding broker-dealer registered representatives? Should a subset of registered investment adviser personnel (such as supervised persons, individuals for whom an adviser must deliver a Form ADV brochure supplement, “investment adviser representatives” as defined in the Advisers Act, or some other group) be required to comply with such requirements?
- How should the continuing education requirement be structured? How frequent should the certification be? How many hours of education should be required? Who should determine what qualifies as an authorized continuing education class?
- How could unnecessary duplication of any existing continuing education requirement be avoided?
- Should these individuals be required to register with the Commission? What information should these individuals be required to disclose on any registration form? Should the registration requirements mirror the requirements of existing Form U4 or require additional information? Should such registration requirements apply to individuals who

⁶⁷ See 913 Study, *supra* note 38, at 138.

provide advice on behalf of SEC-registered investment advisers but fall outside the definition of “investment adviser representative” in rule 203A-3 (because, for example, they have five or fewer clients who are natural persons, they provide impersonal investment advice, or ten percent or less of their clients are individuals other than qualified clients)? Should these individuals be required to pass examinations, such as the Series 65 exam required by most states, or to hold certain designations, as part of any registration requirements? Should other steps be required as well, such as a background check or fingerprinting? Would a competency or other examination be a meritorious basis upon which to determine competency and proficiency? Would a competency or other examination requirement provide a false sense of security to advisory clients of competency or proficiency?

- If continuing education requirements are a part of any licensing requirements, should specific topics or types of training be required? For example, these individuals could be required to complete a certain amount of training dedicated to ethics, regulatory requirements or the firm’s compliance program.
- What would the expected benefits of continuing education and licensing be? Would it be an effective way to increase the quality of advice provided to investors? Would it provide better visibility into the qualifications and education of personnel of SEC-registered investment advisers?
- What would the expected costs of continuing education and licensing be? How expensive would it be to obtain the continuing education or procure the license? Do those costs scale, or would they fall more heavily on smaller advisers? Would these

requirements result in a barrier to entry that could decrease the number of advisers and advisory personnel (and thus potentially increase the cost of advice)?

- What would the effects be of continuing education and licensing for investment adviser personnel in the market for investment advice (*i.e.*, as compared to broker-dealers)?
- What 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?

B. Provision of Account Statements

Fees and costs are important to retail investors,⁶⁸ but many retail investors are uncertain about the fees they will pay.⁶⁹ The relationship summary that we are proposing in a concurrent release would discuss certain differences between advisory and brokerage fees to provide investors more clarity concerning the key categories of fees and expenses they should expect to pay, but would not require more complete, specific or personalized disclosures or disclosures about the amount of fees and expenses.⁷⁰ We believe 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. Clients would receive account statements close in time to the assessment of periodic account fees, which

⁶⁸ See Staff of the Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Aug. 2012), at iv, available at <https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf> (“With respect to financial intermediaries, investors consider information about fees, disciplinary history, investment strategy, conflicts of interest to be absolutely essential.”).

⁶⁹ See Angela A. Hung, et al., RAND Institute for Civil Justice, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (2008), at xix, available at https://www.sec.gov/news/press/2008/2008-1_randiabreport.pdf (“In fact, focus-group participants with investments acknowledged uncertainty about the fees they pay for their investments, and survey responses also indicate confusion about the fees.”).

⁷⁰ See Form CRS Proposal, *supra* note 6, at Section II.B.4.

could be an effective way for clients to understand and evaluate the cost of the services they are receiving from their advisers.

Broker-dealers are required to provide confirmations of transactions with detailed information concerning commissions and certain other remuneration, as well as account statements containing a description of any securities positions, money balances or account activity during the period since the last statement was sent to the customer.⁷¹ Broker-dealers generally must provide account statements no less than once every calendar quarter. Brokerage customers must receive periodic account statements even when not receiving immediate trade confirmations.⁷² Although we understand that many advisers do provide clients with account statements, advisers are not directly required to provide account statements under the federal securities laws. Notably, however, the custody rule requires advisers with custody of a client's assets to have a reasonable basis for believing that the qualified custodian sends an account statement at least quarterly.⁷³ In addition, in any separately managed account program relying on rule 3a-4 under the Investment Company Act of 1940, the program sponsor or another person designated by the sponsor must provide clients statements at least quarterly containing specified information.⁷⁴

We request comment on whether we should propose rules to require registered investment advisers to provide account statements, either directly or via the client's custodian, regardless of whether the adviser is deemed to have custody of client assets under Advisers Act

⁷¹ See, e.g., NASD Rule 2340; FINRA Rule 2232; MSRB Rule G-15. See also Exchange Act rule 15c3-2 (account statements); Exchange Act rule 10b-10 (confirmation of transactions).

⁷² See Confirmation of Transactions, Securities Exchange Act Release No. 34962 (November 10, 1994).

⁷³ Advisers Act rule 206(4)-2(a)(3) (custody rule). The Commission also has stated that an adviser's policies and procedures, at a minimum, should address the accuracy of disclosures made to investors, clients, and regulators, including account statements.

⁷⁴ Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] ("Investment Company Act") rule 3a-4(a)(4).

Rule 206(4)-2 or the adviser is a sponsor (or a designee of a sponsor) of a managed account program relying on the safe harbor in Investment Company Act rule 3a-4.

- To what extent do retail clients of registered investment advisers already receive account statements? To what extent do those account statements specify the dollar amounts charged for advisory fees and other fees (*e.g.*, brokerage fees) and expenses? Would retail clients benefit from a requirement that they receive account statements from registered investment advisers? If clients are uncertain about what fees and expenses they will pay, would they benefit from a requirement that, before receiving advice from a registered investment adviser, they enter into a written (including electronic) agreement specifying the fees and expenses to be paid?
- What information, in addition to fees and expenses, would be most useful for retail clients to receive in account statements? Should any requirement to provide account statements have prescriptive requirements as to presentation, content, and delivery? Should they resemble the account statements required to be provided by broker-dealers, under NASD Rule 2340 with the addition of fee disclosure?
- How often should clients receive account statements?
- How costly would it be to provide account statements? Does that cost depend on how those account statements could be delivered (*e.g.*, via U.S. mail, electronic delivery, notice and access)? Are there any other factors that would impact cost?

C. Financial Responsibility

Broker-dealers are subject to a comprehensive financial responsibility program. Pursuant to Exchange Act rule 15c3-1 (the net capital rule), broker-dealers are required to maintain minimum levels of net capital designed to ensure that a broker-dealer under financial stress has

sufficient liquid assets to satisfy all non-subordinated liabilities without the need for a formal liquidation proceeding.⁷⁵ Exchange Act rule 15c3-3 (the customer protection rule) requires broker-dealers to segregate customer assets and maintain them in a manner designed to ensure that should the broker-dealer fail, those assets are readily available to be returned to customers.⁷⁶ Broker-dealers are also subject to extensive recordkeeping and reporting requirements, including an annual audit requirement as well as a requirement to make their audited balance sheets available to customers.⁷⁷ Broker-dealers are required to be members of the Securities Investor Protection Corporation (“SIPC”), which is responsible for overseeing the liquidation of member broker-dealers that close due to bankruptcy or financial trouble and customer assets are missing. When a brokerage firm is closed and customer assets are missing, SIPC, within certain limits, works to return customers’ cash, stock, and other securities held by the firm. If a firm closes, SIPC protects the securities and cash in a customer’s brokerage account up to \$500,000, including up to \$250,000 protection for cash in the account.⁷⁸ Finally, FINRA rules require that broker-dealers obtain fidelity bond coverage from an insurance company.⁷⁹

Under Advisers Act rule 206(4)-2, investment advisers with custody must generally maintain client assets with a “qualified custodian,” which includes banks and registered broker-dealers, and must comply with certain other requirements.⁸⁰ In 2009 the Commission adopted amendments to the custody requirements for investment advisers that, among other

⁷⁵ See Exchange Act rule 15c3-1.

⁷⁶ See Exchange Act rule 15c3-3.

⁷⁷ See Exchange Act rules 17a-3, 17a-4, and 17a-5.

⁷⁸ See Securities Investor Protection Act of 1970, Public Law No. 91-598, 84 Stat. 1636 (Dec. 30, 1970), 15 U.S.C. § 78aaa through 15 U.S.C. § 78lll.

⁷⁹ See FINRA Rule 4360, (“Fidelity Bonds”).

⁸⁰ See Advisers Act rule 206(4)-2.

enhancements, required all registered investment advisers with custody of client assets to undergo an annual surprise examination by an independent public accountant. SEC-registered investment advisers, however, are not subject to any net capital requirements comparable to those applicable to broker-dealers, although they must disclose any material financial condition that impairs their ability to provide services to their clients.⁸¹ Many investment advisers have relatively small amounts of capital, particularly compared to the amount of assets that they have under management.⁸² When we discover a serious fraud by an adviser, often the assets of the adviser are insufficient to compensate clients for their loss. In addition, investment advisers are not required to obtain fidelity bonds, unlike many other financial service providers that have access to client assets.⁸³

In light of these disparities, we request comment on whether SEC-registered investment advisers should be subject to financial responsibility requirements along the lines of those that apply to broker-dealers.

- What is the frequency and severity of client losses due to investment advisers' inability to satisfy a judgment or otherwise compensate a client for losses due to the investment adviser's wrongdoing?
- Should investment advisers be subject to net capital or other financial responsibility requirements in order to ensure they can meet their obligations, including compensation

⁸¹ See Form ADV. Many states have imposed fidelity bonding and/or net capital requirements on state-registered investment advisers. Rule 17g-1 under the Investment Company Act of 1940 requires registered investment companies to obtain fidelity bonds covering their officers and employees who may have access to the investment companies' assets.

⁸² See Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2968 (Dec. 30, 2009).

⁸³ Fidelity bonds are required to be obtained by broker-dealers (FINRA Rule 4360; New York Stock Exchange Rule 319; American Stock Exchange Rule 330); transfer agents (New York Stock Exchange Rule Listed Company Manual §906); investment companies (17 CFR 270.17g-1); national banks (12 CFR 7.2013); federal savings associations (12 CFR 563.190).

for clients if the adviser becomes insolvent or advisory personnel misappropriate clients' assets?⁸⁴ Do the custody rule and other rules⁸⁵ under the Advisers Act adequately address the potential for misappropriation of client assets and other financial responsibility concerns for advisers? Should investment advisers be subject to an annual audit requirement?

- Should advisers be required to obtain a fidelity bond from an insurance company? If so, should some advisers be excluded from this requirement?⁸⁶ Is there information or data

⁸⁴ We note that Congress and the Commission have considered such requirements in the past. In 1973, a Commission advisory committee recommended that Congress authorize the Commission to adopt minimum financial responsibility requirements for investment advisers, including minimum capital requirements. *See* Report of the Advisory Committee on Investment Management Services for Individual Investors, Small Account Investment Management Services, Fed. Sec. L. Rep. (CCH) No. 465, Pt. III, 64-66 (Jan. 1973) (“Investment Management Services Report”). Three years later, in 1976, the Senate Committee on Banking, Housing and Urban Affairs considered a bill that, among other things, would have authorized the Commission to adopt rules requiring investment advisers (i) with discretionary authority over client assets, or (ii) that advise registered investment companies, to meet financial responsibility standards. S. Rep. No. 94-910, 94th Cong. 2d Sess. (May 20, 1976) (reporting favorably S. 2849). S.2849 was never enacted. In 1992, both the Senate and House of Representatives passed bills that would have given the Commission the explicit authority to require investment advisers with custody of client assets to obtain fidelity bonds. S.226, 102d Cong., 2d Sess. (Aug. 12, 1992) and H.R. 5726, 102d Cong. Ed (Sept. 23, 1992). Differences in these two bills were never reconciled and thus neither became law. In 2003, the Commission requested comment on whether to require a fidelity bonding requirement for advisers as a way to increase private sector oversight of the compliance by funds and advisers with the federal securities laws. The Commission decided not to adopt a fidelity bonding requirement at that time, but noted that it regarded such a requirement as a viable option should the Commission wish to further strengthen compliance programs of funds and advisers. Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25925 (Feb. 5, 2003).

⁸⁵ *See, e.g.*, Advisers Act rule 206(4)-7 (requires each investment adviser registered or required to be registered with the Commission to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and Advisers Act rules, review those policies and procedures annually, and designate an individual to serve as a chief compliance officer).

⁸⁶ As noted above, the 1992 legislation would have given us the explicit authority to require bonding of advisers that have custody of client assets or that have discretionary authority over client assets. Section 412 of ERISA [29 U.S.C. 1112] and related regulations (29 CFR 2550.412-1 and 29 CFR 2580) generally require that every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan shall be bonded. Registered investment advisers exercising investment discretion over assets of plans covered by title I of ERISA are subject to this requirement; it does not apply to advisers who exercise discretion with respect to assets in an individual retirement account or other non-ERISA retirement account. In 1992, only approximately three percent of Commission registered advisers had discretionary authority over client assets; as of March 31, 2018, according to data collected on Form ADV, 91 percent of Commission registered advisers have that authority.

that demonstrates fidelity bonding requirements provide defrauded clients with recovery, and if so what amount or level of recovery is evidenced?

- Alternatively, should advisers be required to maintain a certain amount of capital that could be the source of compensation for clients?⁸⁷ What amount of capital would be adequate?⁸⁸
- What would be the expected cost of either maintaining some form of reserve capital or purchasing a fidelity bond? Specifically, in addition to setting aside the initial sum or purchasing the initial bond, what would be the ongoing cost and the opportunity cost for investment advisers? Would one method or the other be more feasible for certain types of investment advisers (particularly, smaller advisers)?
- Would the North American Securities Administrators Association Minimum Financial Requirements For Investment Advisers Model Rule 202(d)-1⁸⁹ (which 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), provide an appropriate model for a minimum capital requirement? Why or why not?

⁸⁷ See *supra* note 84.

⁸⁸ Section 412 of ERISA provides that the bond required under that section must be at least ten percent of the amount of funds handled, with a maximum required amount of \$500,000 (increased to \$1,000,000,000 for plans that hold securities issued by an employer of employees covered by the plan).

⁸⁹ NASAA Minimum Financial Requirements For Investment Advisers Model Rule 202(d)-1 (Sept. 11, 2011), available at <http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Minimum-Financial-Requirements.pdf>.

- Although investment advisers are required to report specific information about the assets that they manage on behalf of clients, they are not required to report specific information about their own assets.⁹⁰ Should advisers be required to obtain annual audits of their own financials and to provide such information on Form ADV? Would such a requirement raise privacy concerns for privately held advisers?

By the Commission.

Dated: April 18, 2018.

Brent J. Fields
Secretary

⁹⁰ Form ADV only requires that advisers with significant assets (at least \$1 billion) report the approximate amount of their assets within one of the three ranges (\$1 billion to less than \$10 billion, \$10 billion to less than \$50 billion, and \$50 billion or more). Item 1.O of Part 1A of Form ADV.