SEC Clarifies Federal Fiduciary Duties of Investment Advisers

By Scott H. Moss and Manas Kumar

The Securities and Exchange Commission (the SEC) recently sought to clarify its position on federal fiduciary duties of investment advisers with an interpretation. The interpretation emphasized how client sophistication and the scope of an advisory relationship affect the fiduciary duties owed to particular clients.

Determine Scope of Relationship

All advisers owe fiduciary duties under the Investment Advisers Act of 1940, as amended (the Advisers Act). The fiduciary duty of an investment adviser under the Advisers Act consists of a duty of care and a duty of loyalty. Regardless of client sophistication, contracts between advisers and clients can never (i) state that the adviser will not act as a fiduciary, (ii) provide a blanket waiver of all conflicts of interest, or (iii) issue a waiver of any specific obligations under the Advisers Act. However, the nature of the client and the scope of the contractual relationship between adviser and client determine the extent of the fiduciary duties. Advisers serving retail clients, particularly in an ongoing relationship, face heightened standards in fulfilling their duties compared to those of advisers of institutions, registered investment companies, or private funds.

a. Duty of Care

i. Duty to Provide Advice in the Best Interest of the Client

All advisers must provide advice that is in the best interest of the client by developing a reasonable understanding of the client’s objectives. The client’s best interest depends on the type of client. Advisers must understand retail investors’ investment profiles (collecting, oftentimes periodically, detailed information on an individual’s financial situation, level of financial sophistication, investment experience, and financial goals). Advisers must understand only institutional investors’ investment mandates (an investor’s objectives regarding the portion of the portfolio that the adviser is assisting on rather than the objectives of the entire portfolio). For registered investment companies and private funds, advisers need understand and follow only investment guidelines and objectives (i.e., the constitutional documents). All advisers should consider how a particular transaction strategy would most favor a particular client under the circumstances.

ii. Duty to Seek Best Execution

All advisers must seek the best means to execute trades that will maximize value and minimize costs under the circumstances. Maximizing value does not mean that advisers must use the lowest-possible commission cost. An adviser must consider an expansive list of factors in planning trades. For example, an adviser should periodically and systematically account for the full range and quality of a broker, the value of research, the ability to execute trades, the fees, and the broker’s responsiveness.

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

The scope of an advisory relationship also influences how frequently an adviser must provide advice and monitor an account. An adviser compensated periodically by an ongoing client should monitor such client’s account extensively (and consistent with any contractual obligations). In contrast, advising on a one-time plan warrants only advising and monitoring for the duration of a consultation.

b. Duty of Loyalty

i. Subordinate an Adviser’s Interests to Its Client’s Interests, and Disclosing Material Facts

All investment advisers must subordinate their interests to those of their respective clients.

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1 The Interpretation is available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.
Therefore, all advisers must provide full and fair disclosure of all material facts relating to an advisory relationship to fulfill the duty of loyalty. Advisers can satisfy their duty of loyalty in part by either (i) eliminating conflicts of interest or (ii) disclosing such conflicts.

ii. Sufficient Specificity: More Than “Other Clients” or “May Occur”

Full and fair disclosure requires sufficiently specific details so that clients can understand a material fact or a conflict of interest and make an informed decision to consent to the relationship. Advisers must do more than disclose that they have “other clients.” Advisers must describe how they will manage such conflicts and when conflicts will occur. In addition, when the conflict already exists, it is inadequate for advisers merely to disclose that a particular conflict “may” occur without further detail. The term “may” is appropriate when disclosing potential conflicts that have not yet happened but might reasonably occur.

The particular scope of a relationship, the specific nature of a client, and the actual material facts or conflicts influence the level of detail needed for full and fair disclosure. All advisers must disclose information so that clients understand the nature of a conflict of interest. At no time may advisers infer or accept consent when the adviser is aware or reasonably aware that the client did not understand the conflict’s nature and significance. Scope and client type also affect adequate communication of conflicts of interest. It may be too difficult for an adviser to disclose complex conflicts in a manner that retail investors can understand. In such cases, the adviser must either eliminate the conflict or modify its practices to reduce conflicts to a level that clients can comprehend. Advisers stand a better chance of gaining informed consent from institutions without resorting to such measures, as institutions have more resources to research the conflicts.

iii. Allocating Investment Opportunities

Allocating investment opportunities among clients requires advisers to manage conflicts of interests with and among clients. To permit informed consent, an adviser may either eliminate such conflicts or fully and fairly disclose them, including disclosing how the adviser allocates opportunities. Advisers may consider the nature and objectives of clients and the scope of each relationship in allocating investments. Pro rata allocation or any other particular allocation methodology is not mandated.

Takeaways

The SEC detailed more obligations on advisers serving retail investors than on advisers serving institutions, including private funds. Advisers of private funds must largely adhere to their advisory agreements and other organizational and offering documents containing specific disclosure in order to uphold their duty of care and duty of loyalty. In contrast, advisers serving retail investors must periodically update their understanding of an individual’s changing investment goals and offer more details to disclose conflicts (which must be relatively simple to understand).

Advisers of retail investors in particular should revisit their operations to ensure that they are keeping up with clients’ goals and tailoring disclosures based on the clients’ level of sophistication. Advisers of private funds should review their governing documents and disclosure practices to make sure they reflect the services provided.

Please contact Scott H. Moss or your regular Lowenstein Sandler contact if you have any questions with respect to the SEC’s interpretation regarding standards of conduct for investment advisers.

Contacts

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