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# The SEC Proposes Rules Governing Investment Advisers' Dealings with Retail Investors

In recent years, improving the protection of retail investors has been a main focus of the Securities and Exchange Commission ("**SEC**"). On October 26, 2017, Stephanie Avakian, co-director of the Division of Enforcement, referred to protecting retail investors as one of the SEC's "more critical priorities." The same sentiment was echoed by Jay Clayton, Chairman of the SEC, in a speech on May 2, 2018. As part of this endeavor, on April 18, 2018, the SEC proposed new regulations for investment advisers transacting with retail investors. This note discusses the proposed rules, which include an interpretation of fiduciary duty under the Investment Advisers Act of 1940 (the "**Advisers Act**"), enhanced investment adviser regulations borrowed from the existing broker-dealer regulatory framework, and a new disclosure requirement obligating investment advisers to provide a relationship summary to retail investors.

## NEW INTERPRETATION OF FIDUCIARY DUTY

Under the Advisers Act, an investment adviser owes a fiduciary duty to its clients, which cannot be negotiated away or waived by the clients in any manner. In its proposal, the SEC sought to reaffirm and clarify the fiduciary duty standard to which an adviser should adhere, in particular with regard to its retail clients.

- *Duty of care - Duty to provide advice that is in the client's best interest*. The SEC's proposal would require that an investment adviser make reasonable inquiries into a retail client's circumstances (including his/her financial situation, level of financial sophistication, investment experience, and investment objectives) to build an informative investment profile at the beginning of the relationship. The profile then would need to be updated on an ongoing basis, taking into account any changes of law that may be applicable to the client and any changes to his/her personal situation. Once a profile was built, an investment adviser would be required to tailor the investment strategy to the best interest of the client based on his/her profile.

- *Duty of care - Duty to seek best execution*. The SEC noted that investment advisers have a duty to seek best execution, which should be determined by considering all aspects of a client's investment profile at the time of any given transaction, rather than looking solely at whether the client was charged the lowest possible commission cost. In addition, under the SEC proposal, investment advisers would be required to periodically and systematically review all transaction executions they have received to ensure they are maximizing value for their clients.
- *Duty of care - Duty to act and to provide advice and monitoring over the course of the relationship*. To the extent the adviser/client relationship extends beyond one single investment, the SEC's proposal would require investment advisers to adjust their services to account for the scope and duration of the relationship and proactively monitor investments made on behalf of their clients throughout the course of the relationship.
- *Duty of loyalty*. As a fiduciary, an investment adviser must put its clients' interest before its own interest. Moreover, an investment adviser must allocate investment opportunities fairly and equitably among its clients and should not favor clients that pay higher fee rates over others. The SEC clarified that a duty of loyalty would require investment advisers to disclose all material information relevant to their relationships with their clients, including, without limitation, any material conflicts of interests (current or potential), so that a client can make an informed decision. Notwithstanding the fact that a client's consent to a conflict of interest can be either explicit or implicit, the SEC proposed that such consent should not be accepted if (i) the circumstances indicate that the client does not fully appreciate the conflict, or (ii) any material facts are not disclosed fairly and fully. In those cases, advisers would be required to make an effort to eliminate or adequately mitigate the conflict so that they can disclose such conflict in an easily understandable manner.

## ENHANCED INVESTMENT ADVISER REGULATIONS

The SEC identified several areas in the current broker-dealer regulatory framework that do not have a counterpart in the investment adviser context, and proposed the following rules to address those gaps.

- *Federal licensing and continuing education*. Similar to the Financial Industry Regulatory Authority registration process for persons associated with broker-dealers, personnel of SEC-registered investment advisers would be required to pass threshold examinations and hold certain qualifications throughout their practice to ensure both minimum and ongoing competency.
- *Provision of account statements*. This proposed requirement is designed to address the uncertainty many retail investors have with regard to fees and expenses charged against their accounts. Under the proposed formulation, investors would receive detailed account statements periodically and close in time to the fee assessment to help them understand and evaluate the services provided by their advisers.
- *Financial responsibility*. Investment advisers would be required to maintain net capital and/or fidelity bonding comparable to those maintained by broker-dealers.

## RELATIONSHIP SUMMARY AND OTHER NEW DISCLOSURE REQUIREMENTS

Another important element of the SEC proposal is the new client-relationship summary ("**Form CRS**") requirement under Part 3 of Form ADV and Rule 204-5 of the Advisers Act. The new rules would require investment advisers to provide their prospective or existing retail investors with a relationship summary at the beginning of their relationship, which would then be updated within thirty (30) days following a material change. Such summary and any updates thereto would be subject to filing and recordkeeping requirements and would be in addition to, not in lieu of, any existing required disclosures.

We note the following requirements regarding Form CRS. First, Form CRS would be a written disclosure statement limited to four (4) pages, with a mix of tabular and narrative information. Secondly, it must cover the following eight (8) items under prescribed headings in the following order: (i) introduction; (ii) the relationships and services the firm offers to retail investors; (iii) the standard of conduct applicable to those services; (iv) the fees and costs that retail investors will pay; (v) comparisons of services (for standalone investment advisers); (vi) conflicts of interest; (vii) where to find additional information, including whether the firm and its financial professionals currently have reportable legal or disciplinary events and who to contact about complaints; and (viii) key questions for retail investors to ask the firm's financial professional.

- *Introduction*. This portion of the proposed Form CRS would require an introductory paragraph that briefly explains the types of accounts and services the firm offers.
- *Relationship and Services.* This item would require the adviser to explain what types of fees will be charged, how often investment advisers offer their advice, whether investment advisers exercise investment discretion and whether there is any limitation on the types of investments available to retail investors. If the investment adviser has affiliates that are also investment advisers, they would be required to disclose if advisory services by such affiliate would be offered.
- *Standard of Conduct*. Investment advisers would be required to use prescribed wording to disclose (i) that they owe a fiduciary duty to their clients and describe what that entails, and (ii) the possibility of a conflict of interest between them and their clients.
- *Fees and Costs*. This item would require a description of the principal type of fees that the firm will charge as compensation for its advisory services. For retail investors participating in wrap fee programs, an overview of the program would be required. Firms would also be required to communicate that advisory fees will reduce the value of a client's investment and will impact the incentive of its financial professionals.
- *Comparison*. Investment advisers would be required to include a comparison of their fees, services, standard of conduct and incentives against what a typical adviser would offer. To help investors better understand the differences, the SEC proposal suggests using a tabular table to compare certain specified characteristics of a transaction-based fee and an ongoing asset-based fee side-by-side.
- *Conflicts of Interest*. This item would require investment advisers to disclose conflicts relating to (i) financial incentives to offer to, or recommend that retail investors invest in, certain investments because (a) they are issued, sponsored or managed by the firm or its affiliates, (b) third parties compensate the firm when it recommends or sells the investments, or (c) both; (ii) financial incentives to offer to, or recommend that the investor invest in, certain investments because the manager or sponsor of those investments or another third party (such as an intermediary) shares revenue it earns on those products with the firm; and (iii) the firm buying investments from and selling investment to a retail investor for the firm's own account (i.e., principal trading).
- *Additional Information*. This item would need to include where retail investors can find more information about the firm's disciplinary events (if any), services, fees, and conflicts. Investment advisers would be required to direct retail investors to its Form ADV Part 2 brochure as well as any supplements provided by their financial professional.
- *Key Questions*. Investment advisers would be required to include ten (10) questions applicable to their business. The SEC proposed a list of potential topics including, but not limited to, costs and expenses that may be charged to a client's account, most common conflicts of interest and how they are addressed, and disciplinary history, if any, the adviser has been subject to. The firms are encouraged to modify the list as needed to tailor to their specific business model.

Furthermore, to mitigate investor confusion, the SEC proposed that investment advisers should disclose prominently in print or electronic communications to retail investors that they are investment advisers rather than broker-dealers. Additionally, investment advisers, their associated natural persons, and their supervised persons would need to disclose in retail investor communications the firm's registration status with the SEC, and each of the natural person's relationship with the firm.

## CONCLUSION

At the current stage, the foregoing SEC proposals are still subject to a ninety (90) day public comment period, which will end on August 7, 2018. After reviewing the comments, the SEC will need to vote to finalize the rule. Therefore, it is difficult at this stage to foresee what the final rules will entail or to determine the practical implications they may have on investment advisers' legal and business practice. The Private Funds group at King & Spalding LLP will closely monitor and keep you informed of any developments, and is happy to assist should you have any questions.