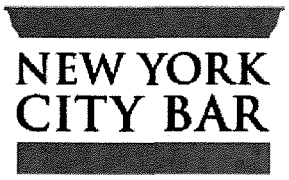

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June 26, 2018

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Investment Advisers Act Release No. 4889 (April 18, 2018))
File No. S7-09-18

Dear Mr. Fields:

This letter is submitted by the Committee on Investment Management Regulation of the New York City Bar Association (the "Committee") and responds to the request of the Securities and Exchange Commission (the "Commission") for comment in Release No. IA-4889 (April 18, 2018) (the "Release"), in which the Commission proposes an interpretation of the standard of conduct for investment advisers (the "Proposed Interpretation") under the Investment Advisers Act of 1940, as amended (the "Advisers Act").[1] The Committee is composed of lawyers with diverse

[1] 15 U.S.C. 80b. In the Release, the Commission also requests comment on licensing and continuing education requirements for personnel of investment advisers registered under the Advisers Act, delivery of account statements to clients with investment advisory accounts, and financial responsibility requirements for investment advisers registered under the Advisers Act. The Committee's comments herein focus on the

perspectives on investment management issues, including attorneys from law firms and counsel to financial services firms, investment company complexes and investment advisers. A list of our members is attached as Annex A.

The Proposed Interpretation is one of three actions by the Commission delineating proposed rules, standards of conduct and practices for registered broker-dealers and their associated persons in carrying out their relationships with their customers who are retail investors, and addressing aspects of fiduciary duty responsibilities of investment advisers.[2] The Commission states in the Proposed Interpretation that in light of the comprehensive nature of the proposed rulemakings, the Commission believes that it would be appropriate and beneficial to address and "in some cases clarify – certain aspects of fiduciary duty that an investment adviser owes to its clients under Section 206 of the Advisers Act."[3]

The Committee appreciates that the primary purpose of the Commission in issuing the Proposed Interpretation is to set forth (and invite public comment on) its views on aspects of an investment adviser's fiduciary duty to its clients in light of the absence of specific language in the Advisers Act stating that registered investment advisers are "fiduciaries" with respect to their clients and the absence of other provisions in the Advisers Act establishing the contours of an adviser's duty to its clients.[4] In the Proposed Interpretation, the Commission states that "[t]he Advisers Act establishes a federal fiduciary standard for investment advisers (citations omitted)" that is based on "equitable common law principles."[5] In that context, the Committee welcomes the Commission's effort comprehensively to organize its views based on the holdings of several

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aspects of the Proposed Interpretation that describe the standards of conduct proposed by the Commission for investment advisers under the Advisers Act.

2 In Exchange Act Release No. 34-83062 (April 18, 2018) ("Regulation Best Interest"), the Commission proposes a rule that would require all broker-dealers and their associated persons to act in the best interests of their retail customers when making a recommendation of any securities transactions or investment strategy involving securities to such retail customers. Separately, in Release Nos. 34-83063 and IA-4888 (April 18, 2018) ("Form CRS Proposal"), the Commission proposes, among other things, a requirement that registered investment advisers and registered broker-dealers must deliver to retail investors a "relationship summary," detailing information about the nature of the respective firm's legal relationship with and services provided to retail investors; the standard of conduct and fees and costs associated with those services; specified conflicts of interest that might exist in the relationship with such firm's retail investors; and whether the firm and its financial professionals have reportable legal or disciplinary records.

3 Proposed Interpretation at p. 5.

4 Proposed Interpretation at p. 6. The Proposed Interpretation does note at page 8, however, that the fiduciary 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 (emphasis added)" and that "[a]lthough 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 its client." Thus, an investment adviser and the client may shape the nature of their relationship, including the adviser's duty of care (the other aspect of the adviser's duty addressed in the Proposed Interpretation), provided that the client is not led to believe that he or she has waived non-waivable rights of action against the adviser that are provided by federal or state law. *See, e.g.*, Heitman Capital Management (SEC No-Action Letter) (Feb. 12, 2007).

5 Proposed Interpretation at p. 6.

federal courts and the Commission's own experience in cases involving alleged violations of the antifraud provisions of Section 206 of the Advisers Act. If adopted, the Proposed Interpretation would provide a means to promote the uniform interpretation and application of the Advisers Act by the Commission and the federal courts with respect to the conduct of investment advisers in their relationships with their clients.[6]

Nevertheless, the Committee has concerns with certain statements in the Proposed Interpretation about the scope of an investment adviser's fiduciary duty under the Advisers Act, principally with respect to disclosure of an investment adviser's potential or actual conflicts of interest. Therefore, the Committee offers these comments in response to the Commission's request for comment.

The Committee's concerns arise from certain observations in the discussion of the duty of loyalty in the Proposed Interpretation:

- The Role of Disclosure in Establishing the Contours of Fiduciary Duty; and
- The Meaning of "Informed Consent" under the Proposed Interpretation.

1. The Role of Disclosure in Establishing the Contours of Fiduciary Duty. In discussing an investment adviser's duty of loyalty, the Proposed Interpretation states that such duty "requires an investment adviser to put its client's interests first," and that, 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. In addition, an 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.[7]

That language is similar to what Form ADV already requires of registered investment advisers, who are required to distribute the adviser's brochure (Form ADV Part 2A) and brochure supplement (Form ADV Part 2B) to prospective and existing clients. The General Instructions to Form ADV Part 2 state, in pertinent part:

> 3. Disclosure Obligations as a Fiduciary. 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

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6 The Committee notes that the Proposed Interpretation also provides an opportunity to the Commission to reexamine the valuable commentary by the Staff of the Investment Adviser Regulation Office of the Division of Investment Management of the Commission, "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission," March 2013, which sets forth the Staff's view of, among other things, the nature of fiduciary duty applicable to registered investment advisers. The Committee believes that the issuance by the Commission of the Proposed Interpretation provides a useful opportunity to review and clarify some of the interpretations of the Staff.

7 Proposed Interpretation at pp. 15-16.

> 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. To satisfy this obligation, you therefore may have to disclose to clients information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require. You may disclose this additional information to clients in your brochure or by some other means.

The Committee believes that the common law is clear that an adviser has satisfied its duty of loyalty in circumstances in which it seeks to avoid or mitigates conflicts of interest, makes full and fair disclosure of potential or actual conflicts which it believes it may not be possible to avoid or mitigate and obtains the client's consent. As discussed below, this position is consistent with the holding by the U.S. Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*[8] and should be confirmed in the Proposed Interpretation.

Consistent with *Capital Gains*, the Proposed Interpretation notes that that an adviser and its client may shape the relationship between them "when the client receives full and fair disclosure and provides informed consent."[9] However, the Proposed Interpretation also suggests that "disclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty under section 206 of the Advisers Act," citing *Capital Gains* for that proposition.[10]

The Committee appreciates the need for an investment adviser to identify and clearly describe certain conflicts of interest in order to obtain the client's informed consent, but respectfully submits that the Proposed Interpretation misstates the holding in *Capital Gains*. In particular, the Committee respectfully submits that the holding in *Capital Gains* does not stand for the proposition that the existence of a fully disclosed (and consented to) conflict between an adviser and a client, in and of itself, can amount to a breach of an adviser's duty of loyalty to its client.

In *Capital Gains*, the Supreme Court did not delineate the specific elements necessary to make a disclosure of a conflict of interest by an investment adviser to its client sufficient to enable the adviser to uphold its fiduciary duty. In *dicta* on the general nature of fiduciary duty requirements the Court stated that "[c]ourts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation to 'employ reasonable care to avoid misleading' its clients." The Court held that "the Investment Advisers Act of 1940 empowers the courts . . . to require an adviser to make *full and frank disclosure* of his practice of trading on the effect of his recommendation [emphasis added]." The Court's principal conclusion was its finding that it was not necessary to apply common law principles of fraud to prove that an adviser intended to violate the provisions of Section 206 of the Advisers Act, since applying that common law requirement of intentional conduct into the Advisers Act would defeat the "manifest purpose" of Congress, in adopting the Advisers Act, to

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8 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) ("*Capital Gains*").

9 Proposed Interpretation at p. 8.

10 Proposed Interpretation at p. 17.

empower the federal courts to enjoin any practice which operates as a fraud or deceit [under Section 206 of the Advisers Act]; it would undermine that purpose to require proof of intent to injure and actual injury to clients.

Notably, in *Capital Gains* the Court specifically rejected the contention of some proponents of the adoption of the Advisers Act that the Act should require that all actual and potential conflicts of interest must be eliminated. The Court specifically acknowledged that disclosure of conflicts could be sufficient. 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 that was not disinterested (emphasis added)."[11]

The Court further noted that requiring the elimination of conflicts of interest was unnecessary under the issue presented in *Capital Gains*, since the Commission sought "only disclosure of a conflict of interests." In *Capital Gains*, therefore, the Supreme Court appears to have interpreted the fiduciary duty standard under the Advisers Act to recognize that an investment adviser could uphold its fiduciary duty to act in its client's best interest even if there were a conflict of interest between the adviser and its client if the adviser made full and frank disclosure of the conflict and first obtained the client's consent.

In other words, the Supreme Court rejected the idea proposed by some that an investment adviser must eliminate all conflicts of interest with its clients. That was a pragmatic recognition by the Court of the complexities of the operations of contemporary investment advisers, which provide many types of services and products to clients that implicate the adviser's resources and services but that could be deemed to give rise to actual or potential conflicts of interest.

The Committee is sympathetic to the fact that the Proposed Interpretation calls attention to the complexity of the landscape and environment to which disclosure of actual and potential conflicts must be applied, and to the likely difficulties of providing clear and understandable disclosure, which may differ based upon the nature of services being offered and the relative sophistication of prospective clients.

The Committee is concerned by the statement in the Proposed Interpretation that ". . . 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."[12] However, in the absence in the Proposed Interpretation of examples of conflicts that the Commission believes cannot be adequately disclosed, the Committee believes that the Proposed Interpretation is inconsistent with the holding in *Capital Gains.* Again, in *Capital Gains*, the Court states that the Advisers Act reflects the intent of Congress to "eliminate, *or at least expose*, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice that was not disinterested [emphasis added]."

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11 *Capital Gains* at 191-192.

12 Proposed Interpretation at p. 18.

Therefore, the Committee urges the Commission to eliminate or modify the language in the Proposed Interpretation[13] that suggests that an adviser's disclosure of certain actual or potential conflicts of interest cannot adequately be addressed by a client's consent thereto, after full and frank disclosure of them to its clients through its disclosures in the adviser's brochures and any other disclosures the adviser makes to its client, including Form CRS (if that Form is adopted), and in any discussions with the client prompted by those disclosures.

2. The Meaning of "Informed Consent" under the Proposed Interpretation. In its discussion of the extent of an investment adviser's duty of loyalty to its clients, the Proposed Interpretation states that

> an 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 [emphasis added].[14]

The Committee believes that it is appropriate that the Proposed Interpretation does not attempt to set forth specific elements of what constitutes an "informed consent" or the process by which such consent is obtained or otherwise to guide investment advisers as to the fulfillment of that obligation with respect to disclosure of conflicts of interest. The implication is that whether a particular client's consent is "informed" will be a highly subjective determination. For investment advisers that offer a strategy or account to many (in some cases, hundreds or thousands of) different clients, making a subjective, case-by-case determination whether each client's consent is "informed" may be extraordinarily costly, if not impossible. It should be sufficient to infer informed consent if, in the words of *Capital Gains*, the adviser has employed "reasonable care to avoid misleading" its clients with respect to those conflicts.

There are a number of discussion points in the Proposed Interpretation about some aspects of the process by which investment advisers should make disclosures about conflicts of interest. That discussion may suggest that if an adviser follows such a process it should have a reasonable basis to believe that it has disclosed enough information about a conflict to enable its client to make a decision that is "informed."

For example, the Proposed Interpretation variously states that "[a]ny 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,"[15] and that "[a]n adviser must provide the client with sufficiently specific facts so that the client is able to understand the adviser's conflicts of interest and business practices well enough to make an informed decision."[16] That requirement should not be read to imply that the adviser has an obligation to test the comprehension of the particular client. It should be sufficient that the disclosure is clear, accurate and detailed enough to inform a reasonable client

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13 See text accompanying Note 10, *supra.*

14 Proposed Interpretation at p. 16.

15 Proposed Interpretation at p. 17.

16 Proposed Interpretation at pp. 17-18.

about a conflict or conflicts and that the individual client acknowledges the disclosure either by specific response or by accepting the adviser's continuing service.

As noted above, the Committee is concerned about the statement in the Proposed Interpretation that ". . . 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." That generalized language could cast a cloud over the reasonable efforts of investment advisers that provide disclosure of actual or potential conflicts to clients to use their reasonable business judgement to make a determination that the client's consent to the conflict could be relied upon as "informed." The adviser should be able to rely on a statement by the client in those cases (as in all others) that it has heard or read and understands the explanation of the conflict of interest and provides its consent thereto or to infer such consent by the client's continuation of its business relationship with the adviser after receiving the disclosure.

The Committee believes that the disclosures that an adviser is required to include in its client brochure and the other client disclosure tools the Commission has proposed, including Form CRS (if adopted), provide appropriate means to (in the words of the Proposed Release) "help prompt a conversation between retail investors and their financial professionals about both the conflicts the firm and financial professional have and what steps the firm takes to reduce the conflicts."[17] The Committee believes, however, that the client brochure currently achieves the Commission's objectives.

An investment adviser that finds it practical to do so could choose to obtain written consents. Otherwise, unless the adviser has reason to believe that the client does not understand or agree to the existence of the disclosed potential or actual conflict, the client's willingness to continue to business relationship should be deemed to be sufficient evidence of such informed consent.

In light of the extensive disclosures that are required to be given by advisers to retail clients in the client brochure, which include an extensive description of actual and potential principal conflicts of interest, the Committee believes that the Commission should state that an adviser that provides the required disclosures about conflicts of interest and responds to a client's questions about the conflicts of interest that have been disclosed, has acted reasonably in considering its client's consent to such disclosed conflicts as "informed."[18]

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17 Form CRS Proposal at p. 99. That Proposal further explains (at p. 101) that the Commission is not proposing to require or permit the proposed Form CRS relationship summary disclosure to include specific information about all of the conflicts of interest that are or could be present in an investment adviser's relationship with retail investors, and notes the role of the adviser's brochure under Items 6, 11 and 12 of Part 2A of Form ADV in providing such more complete explanations of what are arguably the more complex, esoteric potential or actual conflicts to which the Commission refers to in the paragraph cited above as being incapable of disclosure.

18 Form CRS, if adopted, would also support the conclusion since it is, in the Commission's words, designed to "help prompt a conversation between retail investors and their financial professionals about both the conflicts the firm and financial professionals have and what steps the firm takes to reduce the conflicts."

* * *

The Committee appreciates the opportunity to comment on the Proposed Interpretation. If we can be of any further assistance in this regard, please call me at [redacted].

Respectfully,

Frank J. Nasta, Chair
Committee on Investment Management Regulation

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