Business Law Section of the State Bar of Texas
Investment Funds Committee

August 7, 2018

Via Electronic Filing: rule-comments@sec.gov

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

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

Dear Mr. Fields:

The undersigned are members of the Investment Funds Committee (the "Committee") of the Business Law Section of the State Bar of Texas. Our practices focus on investment management issues broadly, including regulatory compliance with a particular emphasis on representing managers to private funds. We appreciate the opportunity to comment on both (1) the Securities and Exchange Commission's (the "Commission") proposed interpretation of standards of conduct for investment advisers (the "Fiduciary Proposal") and (2) its proposed enhanced prudential requirements for advisers registered with the Commission, published in File No. S7-09-18 (the "Prudential Requirements Proposal"). While we believe that both proposals have some merit as applied to personalized investment advice provided to retail investors, we are concerned that both proposals go beyond what the Commission is authorized to do by the Investment Advisers Act of 1940 (the "Advisers Act").[1]

The Commission requested comment in the Fiduciary Proposal on the proposed interpretation of fiduciary duties of investment advisers under Section 206 of the Advisers Act and asks: (1) whether the proposed interpretation offers sufficient guidance, and (2) whether the interpretation leaves any issues related to fiduciary duties unaddressed.[2] We are concerned that the Fiduciary Proposal represents an unacknowledged and dramatically expanded view of what it means to be a "fiduciary" under the Advisers Act.

We believe that being a "fiduciary" under the Advisers Act is centered on being an honest agent whose conflicts are fully disclosed. The Fiduciary Proposal would broaden the federal concept of fiduciary to include substantive fiduciary duties by asserting that the duty of loyalty may not be varied through disclosure, and by adding a duty of care. This expanded view would broaden the federal liability of investment advisers and create concepts not rooted in the text of the Advisers Act.

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[1] Specifically, we are concerned that the Fiduciary Proposal exceeds both the statutory language of Section 206 of the Advisers Act (see below) and Section 211(g) of the Advisers Act (which we believe Congress intended as a clear reference to the *Capital Gains* line of cases discussed below).

[2] Proposed Comm'n Interpretation Regarding Standard of Conduct for Inv. Advisers; Request for Comment on Enhancing Inv. Adviser Regulation, Release No. 4889 (Apr. 18, 2018) at *8.

The Commission also sought comments on proposed prudential requirements for investment advisers registered with the Commission and their representatives, including licensing and continued education, regulated account statements, and capital requirements. We do not believe that these proposed requirements are necessary or appropriate for investment advisers or investment adviser representatives, especially with respect to those who only provide advice to sophisticated and institutional clients, including private investment funds. In addition, we believe that the existing bifurcated federal/state regulatory system that allows states to regulate investment adviser representatives who provide advice to retail clients is working. For example, investment advisers registered with the Commission and their representatives are already subject to:

1) account statement delivery obligations for investment advisers with custody and those relying on Rule 3a-4 under the Investment Company Act of 1940,
2) the requirement to include financial statements of advisers who hold significant fees paid in advance (those who provide the most risk to clients if they are insolvent), and to disclose any bankruptcy filings in Item 18 of the Form ADV Part 2A Brochure,
3) the disclosure obligations for information required in Form ADV Part 2B brochure supplements regarding education and background, and
4) state licensing and continuing education requirements.

Sophisticated clients, and, particularly institutional clients, are aware of the impact of the advisory expertise and education required for their particular strategy. They should be able to decide who to retain to provide the advice, consistent with the traditional disclosure role of the United States securities laws and past Commission determinations to treat individuals who provide advice to entities and high-net-worth individuals in a distinct manner.[3] Finally, we believe that the potential regulations described in the Prudential Requirements Proposal, such as bonding requirements and capital tests are not needed given the fact that, unlike brokers, investment advisers generally do not have possession of client securities or funds, and if they do there are adequate protections provide by the custody rule.[4]

Our more detailed responses to the Commission's request for comment on these issues are set forth below.

A. Fiduciaries under the Advisers Act

Based on a review of relevant cases, we believe that being a fiduciary under the Advisers Act is acting as an honest servant who either avoids conflicts of interest or "at least expose[s] all conflicts of interest which might incline an investment adviser—consciously or

[3] *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Release IA-1633, 62 Fed. Reg. 28112 (May 22, 1997) (the "Post NSMIA Adopting Release"), text after note 111. We are particularly concerned that such a proposed one-size-fits-all licensing and training requirement would not be tailored to the diverse needs of investors or the vastly differing areas of expertise needed to make trading decisions within those strategies.

[4] 17 C.F.R. § 275.206(4)-2.

unconsciously—to render advice which was not disinterested."[5] The Fiduciary Proposal would fundamentally shift the federal fiduciary duty toward substantive duties.

The foundation of claims against a dishonest agent is found in Section 206[6] of the Advisers Act because his or her conflicted service would operate as a "fraud, deceit, or similar conduct" if all conflicts are not adequately disclosed. But the Fiduciary Proposal would, if adopted, unmoor fiduciary obligations from the statutory text of the Advisers Act and conflate common law concepts of duties with deception.

We are particularly concerned with two statements in the Fiduciary Proposal. First, we disagree with the statement that "the adviser cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty."[7] Second, we believe the statement that it may be a violation of an investment adviser's fiduciary duty to accept consent to a conflict "where. . . . the material facts concerning the conflict could not be fully and fairly disclosed"[8] is not supported by existing law. These statements are also not consistent with the Commission's recognition in the Fiduciary Proposal that an adviser and its client may shape their relationship through contract where the client receives full and fair disclosure and provides informed consent.[9]

The language of Section 206 prohibits: (i) the use of any "device, scheme, or artifice to defraud," (ii) any "transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," and (iii) "any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[10] We believe that failure to effectively *disclose* the conduct is a required element of any "deceit" or "fraud" in the Advisers Act and other similar statutes.[11] Adequately disclosed conflicts cannot operate as a fraud or deceit, nor does a statutory prohibition of fraud or deceit provide a sufficient basis for imposing positive duties, such as the duty of care.

The contours of being a fiduciary under the Advisers Act have been shaped by federal courts and by the Commission's interpretations and rules, which have historically focused on loyalty and disclosure.[12] The Advisers Act does not explicitly refer to the fiduciary duties of investment advisers. Instead, the U.S. Supreme Court has held that the nature of the

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[5] *Securities and Exchange Comm'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-92 (1963).

[6] 15 U.S.C.A. § 80b-6 (1), (2), and (4) (West).

[7] Proposed Comm'n Interpretation Regarding Standard of Conduct for Inv. Advisers; Request for Comment on Enhancing Inv. Adviser Regulation, Release No. 4889 (S.E.C. Release No. Apr. 18, 2018), text at n. 21.

[8] Fiduciary Proposal, text at n. 48. This language indicates that disclosure may not be sufficient, but does not state in which instances this may occur. We suggest that many of the egregious instances that the Commission may be concerned with, such as the ability to selectively "cherry pick" all good trades, could already be characterized as a disclosure requirement, but that such disclosure must, due to effectively being a principal transaction, be on a transaction-by-transaction basis in order to be effective under the terms of the Advisers Act.

[9] Fiduciary Proposal, text at n. 20.

[10] 15 U.S.C.A. § 80b-6 (1), (2), and (4) (West).

[11] *See United States v. O'Hagan*, 521 U.S. 642, 655 (1997).

[12] *See, e.g., Transamerica Mtg. Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Securities and Exchange Commission v. Capital Gains, supra* note 4; Investment Advisers Act Release No. 3060 (July 28, 2010).

relationship and the Act's antifraud provision, as discussed above, imply a requirement for investment advisers to act in their client's best interest and to avoid or disclose conflicts of interests.[13] In both *Capital Gains* and *Transamerica*, the Supreme Court centered its analysis of the fiduciary duties of an investment adviser on loyalty and disclosure exclusively.[14]

The Fiduciary Proposal signals a shift away from loyalty and disclosure-based views of fiduciary duties as outlined in *Capital Gains* and *Transamerica*, and toward a view focused on substantive duties. We believe the practical consequences of the Commission's proposed interpretation on investment advisers could be severe, and hope that the Commission will recognize that the federal duties of fiduciaries are rooted in the duty of loyalty.

We believe that many of the previous Commission actions cited in the Fiduciary Proposal are more properly characterized as violations of an adviser's duty of loyalty instead of the duty of care (i.e., the adviser deceived the client into believing that it would provide review of securities on which it was providing advice and failed to do so) or the failure to provide effective and specific disclosure.

B. Enhanced Prudential Requirements

The Commission has requested comment on proposed enhanced prudential requirements for investment advisers registered with the Commission and their investment adviser representatives, including licensing and continued education, regulated account statements, and capitalization requirements. While similar regulations may be appropriate for broker dealers under the Securities Exchange Act of 1934, we do not believe they are necessary for investment advisers because of (i) differences in the nature of the business and in client relationships, (ii) protections that already exist under the Advisers Act and state law (which are better tailored to investment advisers and their representatives), and (iii) the inability to hold most client assets. In any event, we believe that these protections are particularly ill-suited for institutional clients and are best left to the states to decide what regulations are needed to protect their citizens who are retail clients.

<u>Licensing and Continuing Education</u>

We do not believe that federal licensing and continuing education requirements are appropriate for investment advisers registered with the Commission or their representatives. We believe that licensing and continuing education requirements for investment adviser representatives that provide advice to retail clients are best left to the states to regulate. Investment advisers to institutional clients, including private investment funds, on the other hand, generally provide advice as to specialized investments or strategies, which may be targeted at a particular need of their clients. A standardized federal licensing examination would necessarily be broad and general, which would be inadequate and irrelevant to test the aptitude and sophistication of these specialized investment advisers. In addition, institutional clients and sophisticated investors are much more likely to determine their overall portfolio needs on their own or with specialized outsourced consultants and to retain many advisers

[13] *See Capital Gains*, *supra* note 4.

[14] *See id*; *see also Transamerica*, *supra* note 12.

with niche expertise to advise as to each strategy.[15] As recognition of institutional clients' and investors' increased sophistication in choosing investment advisers, the Commission previously carved out adviser representatives who only provide advice to qualified clients from state authority.[16]

Retail investment advisers (and broker dealers) perform a different role and are more frequently generalists that are commonly responsible for the entire portfolio or financial plan of their clients, and a general common pool of knowledge may be more beneficial. However, "investment adviser representatives" of retail investment advisers are not excluded from state authority over testing or educational requirements and are already subject to testing requirements in many states.[17] We believe that these states are better suited to regulate the retail investment adviser representative population without adding a federal layer of testing.

Account Statements

We also do not believe that account statements delivered contemporaneously with payment of fees are necessary. While coordinated statements might be helpful to individual clients with limited experience, clients already receive account statements or financial statements from their brokers either directly or through the custody rule requirements. Institutional clients and investors generally have the sophistication to make informed determinations about the cost of adviser services and participate in the negotiation of fees and expenses vigorously.[18] Requiring further statements would be duplicative, unnecessary and potentially confusing, even to retail clients.

Bonding and Capital Requirements

With respect to the Commission's proposed comprehensive financial responsibility program, we believe investment advisers dealing with sophisticated investors should not be treated in the same way as broker dealers. Institutional clients and investors have the sophistication, resources, and experience to investigate the capital of their investment adviser, and have the bargaining power to negotiate for different terms or additional capital retention if they decide it is in their interest to do so. Investment advisers should not be responsible for additional capitalization or fidelity bond coverage to further protect sophisticated investors that are already subject to several layers of protection and are in a position to negotiate that protection. Given that investment advisers generally do not have custody of client securities and funds, bringing investment advisers under the same standards

[15] We believe that this is also true for persons that are investing in private funds. These private funds typically form a small portion of their investor's overall portfolio.

[16] Under Section 203A(b) of the Advisers Act, no state can require the licensing, registration or qualification of a supervised person of an investment adviser unless that person is an "investment adviser representative" with a place of business in that state. Rule 203(A)-3(a)(1) excludes from the definition of "investment adviser representative" a person if (1) less than 6 of that person's clients are natural persons who do not meet the "qualified client" definition under Rule 205-3(d)(1) or (2) no more than 10% of that person's clients are natural persons who do not meet the qualified client test. 17 C.F.R. § 203A-3.

[17] *See* 17 C.F.R. § 203A-3. We note that Texas, California and most other states require testing for their "investment adviser representatives."

[18] 17 C.F.R. § 275.206(4)-2.

imposed on broker dealers is unnecessary and the limited protection that would be provided by those requirements do not warrant the substantial additional costs of implementation.

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We appreciate this opportunity to provide our views on the Fiduciary Proposal and the Prudential Requirements Proposal. We would be pleased to discuss our comments with the Commission or its staff at your convenience. If you would like to discuss our letter, please contact George Lee at 214-661-5524 or glee@polsinelli.com. The above does not necessarily reflect the views of the Business Law Section of the State Bar of Texas or each of the members of the Committee or the firms at which our members are employed or are partners or shareholders.

Respectfully submitted,

George T. Lee
Chair

James A. Deeken
Vice-Chair