PICKARD DJINIS AND PISARRI LLP
ATTORNEYS AT LAW
1990 M STREET, N.W., SUITE 660
WASHINGTON, D.C. 20036
WWW.PICKDJIN.COM

TELEPHONE
(202) 223-4418

FACSIMILE
(202) 331-3813

August 7, 2018

Filed Electronically

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

Re: Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, File No. S7-09-18

Dear Mr. Fields:

We are pleased to submit these comments in response to the above-referenced proposal (the "Proposed Interpretation") which is part of a package of proposals the Commission has issued regarding standards of conduct for investment advisers and broker-dealers, and related matters (collectively, the "IA/BD Proposals").[1] The Proposed Interpretation interprets the existing fiduciary standard of conduct imposed on investment advisers under the Investment Advisers Act of 1940 ("Advisers Act"), and seeks comment on whether the Commission should propose additional rules to align the Advisers Act regulatory regime more closely with the one imposed on broker-dealers under the Securities Exchange Act of 1934 ("Exchange Act"). We will address the other two IA/BD proposals[2] in a forthcoming comment letter.

Pickard Djinis and Pisarri LLP is a law firm specializing in securities regulation relating to investment advisers, broker-dealers and service providers thereto. Our investment adviser client base ranges from federally registered firms with billions of dollars of assets under management to

---

[1] *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation,* Advisers Act Release No. 4889 (April 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/ia-4889.pdf .

[2] These include a proposal to establish a new broker-dealer standard of conduct relating to the provision of investment advice. *Regulation Best Interest*, Exchange Act Release No. 83062 (April 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/34-83062.pdf, and a proposal to require broker-dealers, investment advisers and dual registrants to deliver new relationship summaries to retail clients, a requirement that would entail changes to the existing Form ADV and create disharmony with advisers' existing brochure delivery obligations. *Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles,* Advisers Act Release No. 4888 (April 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/34-83063.pdf.

state-regulated solo practitioners. This letter reflects the opinions of a number of our federally registered adviser clients.

For the reasons explained below, we generally support the Commission's proposed interpretation of the investment adviser fiduciary standard of conduct, subject to minor modifications. We do not, however, support the idea of incorporating new aspects of broker-dealer regulation into the investment adviser regulatory regime, because that initiative fails to recognize the fundamental differences between advisers and broker-dealers, and would impose costs on advisers without offsetting benefits to investors. As an overarching principle, we oppose harmonization for its own sake, and believe that new regulatory burdens should not be imposed on investment advisers unless there is a very good reason to do so.

Interpreting the Fiduciary Standard of Conduct

The Proposed Interpretation explains that the Advisers Act subjects investment advisers to a federal fiduciary standard of conduct that requires advisers at all times to serve the best interests of their clients and not to subordinate their clients' interests to their own.[3] While the parameters of an adviser's relationship with a particular client may be shaped by contract, the adviser may not disclaim, and the client may not waive, the fundamental fiduciary duty.

According to the Proposed Interpretation, the fiduciary standard of conduct for investment advisers is comprised of a duty of care and a duty of loyalty. The duty of care, among other things, entails an obligation (i) to act and provide advice that is in the best interest of the client, (ii) a duty to seek best execution of client transactions where the adviser is responsible for selecting broker-dealers to execute client trades, and (iii) a duty to provide advice and monitoring over the course of the relationship. On a more granular level, the obligation to render advice that is in a client's best interest entails a duty to make and periodically update a reasonable inquiry into a client's "investment profile" and to provide advice that is suitable for and in the best interest of the client, based on that profile. In addition to making a reasonable investigation into the client's needs, an adviser also has a duty to sufficiently investigate the investment in question, in order to reasonably ensure that advice is not based on materially inaccurate or incomplete information.[4] An investment adviser's duty to provide advice and monitoring over the course of the client relationship depends on the scope of the services agreed upon between the adviser and the client, and extends to all personalized advice the adviser provides.[5]

The second prong of the fiduciary standard, the duty of loyalty, forbids an investment adviser to place its own interests above those of its clients or to unfairly favor one client over another. While this duty obliges an adviser to seek to avoid conflicts of interest with its clients, it

---

[3] Proposed Interpretation at 7.

[4] *Id.* at text accompanying note 31.

[5] *Id.* at 14-15. We note that the Proposed Interpretation does not address impersonal advisory services. *Id.* at note 8.

does not prohibit conflicts outright. Instead, the adviser must, at a minimum, fully and fairly disclose to its clients all material conflicts of interest that could affect the advisory relationship. This disclosure must be sufficient to enable the client to understand the conflicts and to make an informed decision regarding consent. Where such disclosure cannot be made, the conflict should either be eliminated or mitigated to the point at which sufficient disclosure is possible.[6]

We appreciate and generally support the Commission's efforts to synthesize case law, legislative history, academic literature, prior Commission releases and other sources to produce a comprehensive explanation of the fiduciary standard of conduct. However, we share the concerns articulated by the Investment Adviser Association ("IAA") about some of the details of this synthesis, and endorse the following IAA suggestions:

- Eliminate the prescriptive definition of "investment profile" and take a more principles-based approach to an adviser's duty to tailor investment advice to a client's particular circumstances.

- Clarify that suitability is a component of best interest and not a separate requirement.

- Confirm that the sufficiency of disclosure about conflicts of interest depends on facts and circumstances, including the characteristics of the client and the scope of the advisory relationship.

- Confirm that client consent to conflicts of interest may be inferred from facts and circumstances and need not be explicit.

- Clarify that the use of the term "may" is not *per se* inappropriate every time a conflict of interest exists. While the term can indicate something that has not yet occurred but could occur in the future, it also can indicate something that already occurs in some circumstances, but not in others. In other words, a conditional state can exist across time (there is no conflict now, but there might be one later) or across circumstances (I have a conflict in some cases now, but in others, I do not). Whether use of the term "may" is misleading depends on the context and circumstances in which it is used.

- Confirm that it is not inconsistent with the duty of loyalty for an adviser to allocate investment opportunities across client and proprietary or affiliate accounts, so long as the adviser adheres to a disclosed policy that is reasonably designed to treat all clients fairly.[7]

---

[6] *Id.* at 18-19.

[7] Letter from Karen L. Barr, President and CEO, Investment Adviser Association, to Brent J. Fields, Secretary, SEC re: *Reg BI Proposing Release, Form CRS Proposing Release, and Proposed Interpretation* (August 6, 2018) at 35-41.

Finally, like the IAA, we do not believe it is necessary or appropriate to codify the fiduciary standard of conduct in a rule, given the principles-based nature of the fiduciary duty and the varied nature of investment advisory relationships.

Potential New Requirements for Investment Advisers

Following up on recommendations made in the post-Dodd Frank 913 Study,[8] the Commission seeks comment on whether to harmonize the IA/BD regulatory regimes by "enhancing" adviser regulation in three areas: (i) financial responsibility; (ii) provision of account statements; and (iii) federal licensing and continuing education. Although we acknowledge that the broker-dealer regulatory framework differs from the Advisers Act regime in each of these areas, we believe it does so appropriately. The functions performed by broker-dealers and investment advisers are fundamentally different, which means that the investor protection needs are different as well. Importing Exchange Act regulations into the Advisers Act regime in the name of harmonization would provide no meaningful benefit to investors, while imposing very real costs on advisers.

Financial Responsibility

The Commission notes that unlike broker-dealers, investment advisers are not subject to net capital requirements, customer asset segregation requirements, annual audit requirements, SIPC membership requirements, or, in most cases, fidelity bond requirements. The Commission acknowledges that the Advisers Act custody rule (Rule 206(4)-2) requires advised assets to be maintained with a qualified custodian that is subject to these or similar protections, that advisers are obliged to disclose any material financial condition that impairs their ability to provide services to clients, and that advisers to ERISA plan assets or mutual funds are subject to or otherwise covered by fidelity bond requirements. Nevertheless, the Commission says that advisers who seriously defraud their clients often lack sufficient assets to compensate clients for their loss. The Commission asks whether federally registered "investment advisers should be subject to financial responsibility requirements along the lines of those that apply to broker-dealers."[9]

In considering this suggestion, it is critical to recognize that broker-dealers and investment advisers perform different functions and operate under different business models. Broker-dealers sell securities, deal with each other on exchanges and in other marketplaces, maintain securities positions and make markets in securities, engage in underwriting and clearance and settlement activities, hold customer assets, lend securities, make margin loans and, *only incidentally*, render investment advice. Investment advisers, on the other hand, exclusively provide investment advice, whether by making investment decisions on behalf of

---

[8] *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.

[9] Proposed Interpretation at 35.

clients, making investment recommendations, or issuing reports about securities. While advisers may communicate with banks, brokers and custodians on clients' behalf, all assets are held, and all aspects of trade execution are handled, by parties who are already subject to financial responsibility regulations. This being the case, there is no need to impose broker-dealer financial responsibility requirements on investment advisers.

For example, the objective of the broker-dealer net capital rule is "to enhance the protection of customer funds and securities held by broker-dealers. . . by requiring all broker-dealers to operate under a sound capital base."[10] Likewise, the asset segregation rule and SIPC insurance come into play only where a broker-dealer is holding client assets, which advisers do not do.

The Advisers Act regime already addresses "the protection of customer funds and securities" and does so in a manner that fits with the way investment advisers operate. The custody rule forbids advisers from having even fleeting possession of client assets, and requires those assets to be held by a "qualified custodian" such as a bank, broker-dealer or in some cases, futures commission merchant or foreign financial institution. In adopting the latest iteration of this rule, the Commission said:

> We believe these amendments, together with the guidance for accountants, will provide for a more robust set of controls over client assets designed to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses.[11]

In addition, advisers who have discretionary authority over, or certain access to, customer assets, or who solicit or require prepayment of more than $1200 in fees more than six months in advance, have a duty to disclose any financial condition that is reasonably likely to impair their ability to meet their contractual commitments to clients.[12] Because the Proposed Interpretation does not suggest that these customer protections are deficient in any way, adding Exchange Act financial responsibility rules to the panoply of adviser regulations would be superfluous.

Furthermore, the Commission has already confirmed that even where investment advisers are forced to quickly and unexpectedly exit the market, client assets typically are not at risk.

> In the normal course of business, it is our understanding that advisers routinely transition client accounts without a significant impact to themselves, their clients, or the financial markets. We believe that much of this is largely attributable to the agency relationship of advisers managing the assets on behalf of their clients and the regulatory

---

[10] *Net Capital Rule, Proposed Uniform and Comprehensive Regulation,* Exchange Act Release No. 9891 (December 5, 1972), 38 Fed. Reg. 56 (January 3, 1973).

[11] *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2968 (December 30, 2009) at 6, *available at* http://www.sec.gov/rules/final/2009/ia-2968.pdf ("Custody Release").

[12] Form ADV, Part 2A, Item 18.B.

> framework supporting this relationship. . . . Because client assets custodied by an adviser must be held at a qualified custodian and segregated from the adviser's assets, we have observed that transitioning accounts from one adviser to another can largely be a streamlined process that in many cases may not involve the physical movement or sale of assets. . . .
>
> In addition, we are aware of instances of non-routine disruptions at large advisory businesses that have resulted in transitions to new advisers or new ownership without appearing to have a significant adverse impact on clients, fund investors, or the financial markets. Advisers routinely enter and exit the market and are capable of transferring client assets to another adviser or distributing such assets back to the client without negatively impacting the client.[13]

While the Commission notes that in cases of "serious fraud" an adviser's assets are often insufficient to compensate clients for their loss, the Commission offers no evidence to suggest that clients would be materially better off if the malefactor had a regulatory minimum amount of net capital or a bond. Indeed, we note that customer recovery also seems to be a problem under the broker-dealer regime, since between 2012 and 2016, a total of roughly $200 million in FINRA arbitration awards went unpaid.[14]

At the end of the day, the idea of harmonizing investment adviser and broker-dealer regulation regarding financial responsibility has little to recommend it. We respectfully urge the Commission not to pursue this endeavor.

Provision of Account Statements

Likewise, we urge the Commission not to impose an account statement delivery requirement on investment advisers.

Noting that broker-dealers are obliged to send confirmations and account statements to clients but investment advisers are not, and suggesting that the receipt of periodic account statements that specify the dollar amount of fees and expenses would help clients understand what they are paying for an adviser's services, the Commission asks whether it should propose rules to require advisers to send account statements to clients "either directly or via the client's custodian."[15] While acknowledging that the Advisers Act custody rule already obliges advisers

---

[13] *Adviser Business Continuity and Transition Plans,* Advisers Act Release No. 4439 (June 28, 2016) at 19-21 (citations omitted), *available at* https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

[14] *See* FINRA, *Discussion Paper* - FINRA Perspectives on Customer Recovery (February 8, 2018) at 7, *available at* http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf. Net capital, asset segregation, audit and fidelity bond requirements certainly did not do much to protect the victims of Madoff's fraud.

[15] Proposed Interpretation at 32.

who have constructive custody to have a reasonable belief, after due inquiry, that the account custodian is sending at least quarterly statements to the client, the Commission asks whether it should require *all* advisers, regardless of whether they have custody, to deliver account statements to clients. The answer is an unequivocal *no.*

Investment advisers charge fees to clients in one of two ways. Some advisers bill clients directly, in which case the clients receive statements clearly informing them how much they owe for advisory services. Other advisers are authorized to direct the client's custodian to debit the account and remit the fees owed. In this latter case, the custody rule requires the custodian to send account statements to the client, showing the amount of advisory fees debited. Since all clients already receive notice of the amount of fees being charged -- either directly from the adviser or through the qualified custodian -- there is no investor benefit to be derived from a duplicate account statement requirement. In fact, in amending the custody rule to eliminate advisers' option to send their own account statements to clients in lieu of custodian statements, the Commission said, "We believe that direct delivery of account statements by qualified custodians will provide greater assurance of the integrity of account statements received by clients."[16] We know of no reason to doubt this assessment.

Furthermore, in our clients' experience, many investors do not want to receive two sets of account statements on a routine basis. As fiduciaries, investment advisers are in the best position to understand and respond to their clients' needs and preferences when it comes to periodic account reporting. Because the nature and frequency of the account reports advisers provide to clients are disclosed in the Form ADV brochures they distribute at the outset of the client relationship,[17] clients have the ability to select an adviser who provides the level of reporting they desire.

By the same token, we do not believe the Commission should require investment advisers to enter into written agreements with their clients, specifying the fees and expenses to be paid. An adviser's fee and billing practices are already disclosed in its regulatory disclosure brochure,[18] and the decision of whether to use a written agreement or not is best left to the parties to the fiduciary advisory relationship.

Federal Licensing and Continuing Education

Noting that associated persons of broker-dealers are subject to FINRA registration, examination and continuing education requirements, the Commission seeks comment on whether it should impose similar requirements on personnel of federally registered investment advisers.[19]

---

[16] Custody Release *supra* note 11 at 7.

[17] Form ADV, Part 2A, Item 13.C.

[18] *Id.* at Item 5.

[19] Proposed Interpretation at 29.

We believe the answer is an unqualified *no*.

At the outset, we question whether the Commission is authorized to mandate the licensing of an investment adviser's personnel. Unlike the typical state blue sky law that makes it unlawful for any person to transact business in the state "as an investment adviser or as an investment adviser representative unless he is so registered" in the state,[20] the registration requirement under the Advisers Act speaks only in terms of an investment adviser, and does not include the adviser's employees or other representatives.[21] Likewise, the allocation of regulatory responsibilities between the SEC and the states enacted by virtue of the National Securities Markets Improvement Act of 1996 ("NSMIA") and codified in Section 203A of the Advisers Act refers to the registration of *investment advisers* at the federal level[22] and *investment advisers or supervised persons of investment advisers* at the state level[23].

Furthermore, we believe that the Commission should not consider a federal licensing regime for advisory personnel unless it first determines that its long-standing interpretation of NSMIA's effect on investment adviser representative regulation is causing harm.

Advisers Act Rule 203A-3 reflects a deliberate, reasoned determination that state licensing and qualification requirements should not apply to all personnel of federally registered advisers, but only to those who deal predominantly with natural persons other than high net worth individuals. In explaining this position, the Commission said:

> The Commission continues to believe that it is consistent with the intent of Congress as reflected in the structure and purpose of [NSMIA] to distinguish between retail and other clients in defining the term investment adviser representative. . . . Because of the historical treatment of wealthy and sophisticated individuals under the federal securities laws, Congress reasonably could have expected these persons not to be considered retail investors.[24]

We are not aware of any instance in which this interpretation has failed to protect institutional or "wealthy and sophisticated" individual investors. Furthermore, we do not see a need for the Commission to adopt a licensing and qualification system to protect small retail investors, because such a system already exists at the state level. We respectfully submit that developing

---

[20] Massachusetts General Laws c. 110A § 201(c); *see also* District of Columbia Code § 31-5602.02; 6 Delaware Code § 73-301.

[21] Advisers Act § 203(a).

[22] *Id.* § 203A(a).

[23] *Id.* § 203A(b).

[24] *Rules Implementing Amendments to the Investment Advisers Act of 1940,* Advisers Act Release No. 1633 (May 15, 1997) at 42-43, *available at* https://www.sec.gov/rules/final/ia-1633.txt.

a federal licensing system for retail-focused representatives would violate the whole purpose of NSMIA, which was to eliminate duplicative regulation.

* * * * *

We appreciate the opportunity to comment on this important interpretive proposal, and would be happy to supply any additional information you may desire.

Respectfully submitted,

Mari-Anne Pisarri

cc: The Honorable Jay Clayton, Chairman
The Honorable Kara M. Stein
The Honorable Robert J. Jackson, Jr.
The Honorable Hester M. Peirce
Dalia Blass, Director, Division of Investment Management