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August 8, 2018

Mr. Brent J. Fields, Secretary
United States Securities and Exchange Commission
100 F. Street, N.W.
Washington, DC 20549-1090

Re: Request for Comment Regarding the Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers (File No. S7-09-18)

Dear Mr. Fields:

We are responding to the request of the Securities and Exchange Commission (the "SEC" or the "Commission") for comments on the proposed interpretation regarding the standard of conduct for investment advisers under the Investment Advisers Act of 1940 (such act, the "Advisers Act," the proposed interpretation, the "Proposed Interpretation," and the final interpretation, the "Interpretation").[1] We recognize the time and effort invested by the Commission and the Staff of the Division of Investment Management (the "Staff") in formulating the Proposed Interpretation and appreciate the opportunity to comment.

Schulte Roth & Zabel LLP is an international law firm, with offices in New York, London and Washington, D.C. Our clients include many advisers to private investment funds, and we regularly counsel clients with respect to structuring and operating their investment advisory businesses in compliance with their legal obligations. These comments, while informed by our experience in representing these clients, represent our own views and are not intended to reflect the views of the clients of the firm.

I. Introduction

On April 18, 2018, the Commission issued three proposals addressing the duties and standards applicable to broker-dealers and investment advisers. One proposed rule, "Regulation Best Interest," would require registered broker-dealers and their associated persons to act in the best interest of retail investors when recommending investment strategies or securities transactions to retail customers.[2] The Commission also proposed a rule that would require

[1] Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Advisers Act Release No. IA-4889, 83 Fed. Reg. 21203 (Apr. 18, 2018) (hereinafter "Proposing Release").
[2] Regulation Best Interest, Exchange Act Release No. 83062, 83 Fed. Reg. 21574 (Apr. 18, 2018).

registered investment advisers and registered broker-dealers to deliver a relationship summary to retail investors.[3] In light of these proposed rulemakings, the Commission also considered it appropriate and beneficial to reaffirm and clarify the fiduciary duty that an investment adviser owes to its clients by issuing the Proposed Interpretation.[4]

We appreciate the Commission's efforts to clarify and reaffirm an investment adviser's fiduciary duty. Because this Interpretation will be the Commission's first formal interpretation of an investment adviser's fiduciary duty, the scope of the Interpretation and the specific language used will be critically important. We therefore respectfully submit the following suggestions with respect to the Interpretation:

(i) Consider more clearly distinguishing between retail and sophisticated investors;

(ii) Consider clarifying certain language with respect to the circumstances in which disclosure of a conflict is insufficient; and

(iii) Consider clarifying certain language describing an adviser's duty to eliminate or disclose conflicts.

II. Distinguishing Between Retail and Sophisticated Investors

In proposing its first formal interpretation of an investment adviser's fiduciary duty, the Commission addresses topics critical to all investment advisers, including advisers to private investment funds and the institutional and sophisticated natural person investors in such funds. The context of the Proposed Interpretation, however, is the determination as to the obligations owed to retail clients by broker-dealers, on the one hand, and investment advisers, on the other.[5] Given this context, we suggest that the Commission consider limiting the scope of the Interpretation to the context from which it arises — the retail client.

Such an approach would be consistent with the approach Congress took in Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[6] That section authorized the Commission to create a uniform fiduciary standard and in doing so specifically required that the fiduciary duties of advisers to retail clients be addressed separately from the fiduciary duties of advisers to private investment funds.[7] Although the Commission is not proposing a uniform fiduciary standard for broker-dealers and investment advisers, the distinction made in the statute between retail and private fund clients provides a useful guide in the context of the Proposed Interpretation.

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[3] Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, Exchange Act Release No. 83062, Advisers Act Release No. 4888, 83 Fed. Reg. 21416 (Apr. 18, 2018).

[4] *See* Proposing Release, *supra* note 1, at 5.

[5] *See* Regulation Best Interest, *supra* note 2.

[6] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 913(g), Pub. L. No. 111-203, 124 Stat. 1376, 1828 (codified in 15 U.S.C. § 80b-11(g)).

[7] *See id.* ("the Commission shall not ascribe a meaning to the term 'customer' that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser").

Distinguishing between retail and sophisticated investors is also consistent with the treatment of such investors under existing law and precedent. "Accredited investors" are treated as sufficiently sophisticated to make investments pursuant to Regulation D under the Securities Act of 1933.[8] "Qualified clients" may be charged performance-based compensation under Rule 205-3.[9] "Qualified purchasers" are permitted to invest in funds that are not registered under the Investment Company Act of 1940.[10] We believe that investment advisers and investors would benefit from an Interpretation that more explicitly distinguishes between retail and sophisticated investors as is done elsewhere in the law.

III. The Role of Disclosure in Addressing Conflicts of Interest

In the Proposed Interpretation, the Commission identifies the critical role that disclosure plays in addressing conflicts of interests faced by investment advisers. The specific language used in the Interpretation will have significant consequences to the structuring and operation of investment advisory businesses and relationships. We therefore offer two suggestions for the Commission's consideration.

A. Clarifying Circumstances in Which Disclosure of a Conflict is Insufficient

While focusing mostly on the adequacy of disclosure of conflicts, the Proposed Interpretation also indicates that in some circumstances disclosure is insufficient to satisfy an adviser's fiduciary obligations. The Proposed Interpretation indicates that "[d]isclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act," and consent would not be effective where "the material facts concerning the conflict could not be fully and fairly disclosed."[11]

The Commission cites *SEC v. Capital Gains*[12] and *Arleen Hughes*[13] for the proposition that disclosure is sometimes insufficient.[14] The citation to *SEC v. Capital Gains* is to the legislative history of the Advisers Act, and in particular to a standard that was proposed but not adopted. "[A]n investment counsel should remain 'as free as humanly possible from the subtle influence of prejudice, conscious or unconscious' and 'avoid any affiliation, or any act which subjects his position to challenge in this respect.'"[15] This conflict-free standard is inconsistent

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[8] *See* 17 C.F.R. §§ 230.500 - 230.508.
[9] *See* 17 C.F.R. § 275.205-3.
[10] *See* 15 U.S.C. § 80a–3(c)(7).
[11] Proposing Release, *supra* note 1, at 17, 18 ("For example, 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 duties. In other cases, disclosure may not be specific enough for clients to understand whether and how the conflict will affect the advice they receive. With some complex or extensive conflicts, it may be difficult to provide disclosure that is sufficiently specific, but also understandable, to the adviser's clients. In all of these cases where full and fair disclosure and informed consent is insufficient, we expect an adviser to eliminate the conflict or adequately mitigate the conflict so that it can be more readily disclosed.").
[12] *See* Sec. Exch. Comm'n v. Capital Gains Research Bureau, Inc., 372 U.S. 180 (1963) (hereinafter "SEC v. Capital Gains").
[13] *See* Arleen W. Hughes, Exchange Act Release No. 4048 (1948) (hereinafter "Arleen Hughes").
[14] Proposing Release, *supra* note 1, at 17 n. 44, 18 n. 48.
[15] *Id.* at 17 n. 44 (quoting SEC v. Capital Gains, *supra* note 12, at 188).

with the disclosure regime adopted by the Advisers Act as set forth in *SEC v. Capital Gains*[16] and is inconsistent with the investment advisory businesses that have grown and developed in the past decades. The Proposed Interpretation does not provide examples where full and fair disclosure and informed consent was, or would be, insufficient.

We are concerned the foregoing language could suggest there is a category of conflicts that must always be eliminated, regardless of the sophistication of the investor. If, instead, the language is directed at situations in which conflicts cannot be effectively disclosed because they are complex or extensive and the clients insufficiently sophisticated, we suggest clarifying this point.

B. Clarifying Advisers' Duty to Eliminate or Disclose Conflicts

When describing an investment adviser's fiduciary duty of loyalty, the Proposed Interpretation indicates 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."[17] We are concerned that this language will cause confusion, and therefore suggest the Commission consider a clarification.

The Supreme Court in *SEC v. Capital Gains* articulated the fiduciary requirement of an adviser "to eliminate, or at least to expose, all conflicts of interest."[18] Such language was consistent with the Commission's earlier opinion in *Arleen Hughes*,[19] and has been cited and relied upon in the intervening decades. The terminology "seeking to avoid" a conflict appears to have been introduced relatively recently, and we suggest it be reconsidered before inclusion in the Interpretation.

1. Background of the "Seek to Avoid" Language

The original draft of the Advisers Act imposed a requirement for investment advisers "to mitigate and, so far as is presently practicable to eliminate the abuses enumerated in this section."[20] This requirement, however, was omitted from the version of the Advisers Act that

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[16] *See* SEC v. Capital Gains, *supra* note 12, at 191-92 ("The Investment Advisers Act of 1940 thus reflects a . . . congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser— consciously or unconsciously—to render advice which was not disinterested.")

[17] Proposing Release, *supra* note 1, at 15-16 (emphasis added). In other contexts, however, the Proposed Interpretation quotes the "eliminate, or at least . . . expose" language from *SEC v. Capital Gains*. *Id.* at 6 (quoting SEC v. Capital Gains, *supra* note 12, at 191).

[18] SEC v. Capital Gains, *supra* note 12, at 191.

[19] *See* Arleen Hughes, *supra* note 13.

[20] *Hearings Before a Subcomm. of the Comm. on Banking and Currency on S. 3580: A Bill to Provide for the Registration and Regulation of Investment Companies and Investment Advisers, and for Other Purposes*, 76th Cong. 30 (1940) (listing the following abuses: "(1) when investors are unable to obtain adequate information as to the activities, practices, ability, training, and integrity of investment advisers, their affiliated persons, and employees; (2) when persons of proven lack of integrity in financial matters are permitted to engage in business as investment advisers; (3) when the compensation of investment advisers is based upon profit-sharing contracts and other contingent arrangements conducive to excessive speculation and trading; or (4) when the business of investment advisers is so conducted as to defraud or mislead investors, or to enable such advisers to relieve themselves of their fiduciary obligations to their clients.").

was signed into law, and the final version of the Advisers Act explicitly prohibits fraud but does not explicitly impose fiduciary duties on investment advisers.[21]

The Commission subsequently addressed an adviser's fiduciary obligation in the *Arleen Hughes* case where the investment adviser was charged with failing to disclose that sales of securities to clients were principal transactions.[22] The Commission did not fault the adviser for creating the conflict, but instead indicated that "if registrant chooses to assume a role in which she is motivated by conflicting interests . . . she may do so if, but only if, she obtains her client's consent . . . "[23] In 1963, the Supreme Court articulated this standard in *SEC v. Capital Gains*, an appeal of an SEC enforcement action against a registered investment adviser for failing to disclose that it traded ahead of its clients in securities that it later recommended to clients.[24] The Court "h[e]ld that the Investment Advisers Act of 1940 empowers the courts, upon a showing such as that made here, to require an adviser to make full and frank disclosure of his practice of trading on the effect of his recommendations."[25] The Court described the fiduciary duty as requiring the adviser "to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser—consciously or unconsciously—to render advice which was not disinterested."[26]

Courts since *SEC v. Capital Gains* have interpreted an investment adviser's fiduciary duty to require disclosure or elimination of a conflict of interest.[27] Courts commonly frame a violation as a failure to disclose conflicts of interest, and we are not aware of cases where the SEC charged an adviser for failing to "seek to avoid" the conflict of interest itself.[28]

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[21] *See* Advisers Act, Pub. L. No. 768, 76th Cong., 3d. Sess. (Aug. 22, 1940).
[22] *See* Arleen Hughes, *supra* note 13.
[23] *Id.* at 8.
[24] *See* SEC v. Capital Gains, *supra* note 12.
[25] *Id.* at 197.
[26] *Id.* at 191-92.
[27] *See, e.g.,* Sec. Exch. Comm. v. DiBella, 587 F.3d 553, 568 (2d Cir. 2009) ("The SEC argues that [the defendants], to avoid section 206(2) liability, had a duty: (1) to refrain from taking the Fund investment, or (2) to disclose the fee arrangement 'to another individual in the Treasurer's office not involved in the formation of the agreement in order to avoid injury to the Pension Fund.'"); Belmont v. MB Inv. Partners, Inc., 708 F.3d 470, 503 (3d Cir. 2013) ("the federal fiduciary standard thus focuses on the avoidance or disclosure of conflicts of interest between the investment adviser and the advisory client.").
[28] *See, e.g.,* Monetta Fin. Servs., Inc. v. Sec. Exch. Comm., 390 F.3d 952, 956 (7th Cir. 2004) ("Undoubtedly, allocations of IPO shares to mutual fund directors were commonplace, but [the defendant] has not pointed to any evidence suggesting that investment advisers' non-disclosure of the allocations was also industry practice. . . . [The defendant] had a duty to disclose the fact that it allocated IPO shares to the director-clients. Its failure to do so constituted fraud or deceit within the meaning of Section 206(2)."); Sec. Exch. Comm. v. Tambone, 550 F.3d 106, 146 (1st Cir. 2007) ("Specifically, the complaint alleges that [the Defendant] knowingly allowed preferred investors to engage in shortterm and excessive trading in the Columbia Funds, and that such trading harmed the interests of long-term shareholders. Despite knowledge of these arrangements, [the defendant] knowingly or intentionally failed to disclose the practices, and the conflicts of interest they created. These fraudulent disclosures or omissions allegedly constituted a 'device, scheme, or artifice to defraud' under section 206(1) and a 'practice, or course of business which operates as a fraud or deceit upon any client or prospective client' under section 206(2)."); Sec. Exch. Comm. v. Nutmeg Grp. LLC, 162 F. Supp. 3d 754, 779 (N.D. Ill. 2016) ("Finally, Defendants argue that they disclosed (or effectively disclosed) the asset transfers, payments to Relief Defendants, and commingling . . . Defendants note that some of the Investors were told about the conduct at issue. But that does not ameliorate the breach of fiduciary duty owed to the other Investors.").

It appears that the terminology that advisers must "seek to avoid" conflicts was introduced in 2010, when the Commission amended Form ADV, stating that "[a]n adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict."[29] In doing so, the Commission cited *SEC v. Capital Gains*[30] and *Arleen Hughes*;[31] however, we do not believe that either of these opinions provide for a duty to seek to avoid conflicts. General Instruction 3 to Form ADV, Part 2A also contains the "seek to avoid" language, but does not explain its meaning.[32] The "seek to avoid" language has been quoted in several of the Commission's rulemaking releases, but does not appear to have been explained or relied upon.[33]

The language in General Instruction 3 to Form ADV, Part 2A has been cited in enforcement actions, but these actions addressed failures to disclose a conflict.[34] Speeches by SEC Commissioners and Staff also include the "seek to avoid" terminology from the 2010 ADV amendments, but do not indicate the basis for an obligation to "seek to avoid" conflicts.[35] In contrast, the "Regulation of Investment Advisers," a guide written by the Staff of the Commission's Division of Investment Management and updated in 2013, uses the language of

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[29] Amendments to Form ADV, Advisers Act Release No. 3060, 75 Fed. Reg. 5923 (July 28, 2010).
[30] *See* SEC v. Capital Gains, *supra* note 12.
[31] *See* Arleen Hughes, *supra* note 13.
[32] General Instruction 3, General Instructions for Part 2 of Form ADV, *available at* https://www.sec.gov/about/forms/formadv-part2.pdf.
[33] *See, e.g.,* Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 64766, 76 Fed. Reg. 42396, 42422 n. 188 (June 29, 2011) ("An adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict."); Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 77617, 81 Fed. Reg. 29960, 30019 n. 779 ("We have stated that an adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict.").
[34] Robare Group, Ltd., Initial Decision Release No. 806 (ALJ June 4, 2015) (modification in original) ("The current Form ADV instructs advisers that '[a]s … fiduciary[ies], [they] must seek to avoid conflicts of interest with [their] clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship.'"), *rev'd*, Robare Grp., Ltd., Advisers Act Release No. 4566 (Nov. 7, 2016) (Commission Opinion reversing ALJ decision);. Alison, LLC & Stephen D. Alison, Exchange Act Release No. 32583, Advisers Act Release No. 4673 (Mar. 29, 2017) ("The general instructions for Part 2 of Form ADV specify that . . .[a]s a fiduciary, you also must seek to avoid conflicts of interest with your clients.").
[35] *See, e.g.,* Jay Clayton, Testimony before the Financial Services and General Government Subcommittee of the House Committee on Appropriations (Apr. 26,2018), *available at* https://www.sec.gov/news/testimony/testimony-financial-services-and-general-government-subcommittee-house-committee; Dalia Blass, Remarks at the PLI Investment Management Institute 2018 (Apr. 30, 2018), *available at* https://www.sec.gov/news/speech/blass-remarks-pli-investment-management-institute-2018 ("[an adviser] also 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."); Andrew Ceresney, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (May 12, 2016), *available at* https://www.sec.gov/news/speech/private-equity-enforcement.html ("I hope that these actions will lead other advisers as well to proactively change their practices to seek to avoid conflicts of interest with clients and to ensure, at a minimum, that they are in line with their organizational documents."); Mary Jo White, Five Years On: Regulation of Private Fund Advisers after Dodd-Frank – MFA Outlook 2015 Conference (Oct. 16, 2015), *available at* https://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html ("investment advisers must serve the best interests of their clients and seek to avoid, or at least make full disclosure of, conflicts of interest, including those related to their organization, operation, and management of client assets.").

SEC v. Capital Gains, "eliminate, or at least . . . expose," and does not use the Form ADV, Part 2A Instructions' "seek to avoid" language.[36]

2. Practical Implications

We believe that it is clear what it means for an adviser to eliminate, or at least disclose, a conflict of interest. But it is less clear what is required in order to "seek to avoid" a conflict. Must advisers somehow try to provide clients conflict-free advice, and have proof that they have done so, before determining that a conflict cannot be avoided? Or would it suffice if the adviser evaluated the pros and cons of proceeding with or without the conflict?

Private investment funds are typically offered with disclosures that identify conflicts of interest, allowing the adviser to choose how to structure and operate its business and allowing the prospective investors to choose whether or not to make the investments. For example:

- Investors in private funds are informed that the adviser has other clients, and therefore investments in initial public offerings, private investments, and other limited offerings will be allocated among clients that may be paying different fees.[37]

- A private fund manager may choose to use an affiliate as a service provider for a fund's portfolio company, because it believes that the affiliate is the most knowledgeable and experienced party to provide the service.

- A private fund manager may choose to use "soft dollars" generated by client trades to pay for investment research.

In each of these examples, it is unclear what it would mean for the adviser to "seek to avoid" the conflict at issue.

We believe that the "seek to avoid" language introduces some uncertainty into an adviser's approach to conflicts. We therefore suggest that the Commission either (i) reaffirm the language from *SEC v. Capital Gains* that calls for advisers "to eliminate, or at least to expose all [material] conflicts of interest;"[38] or (ii) clarify that what is required to "seek to avoid" a conflict is that an adviser evaluate the pros and cons of proceeding with or without the conflict.

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[36] *See* STAFF OF THE INVESTMENT ADVISER REGULATION OFFICE, REGULATION OF INVESTMENT ADVISERS (March 2013), *available at* https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.
[37] *See* Items 5 and 6, Part 2A of Form ADV, *available at* https://www.sec.gov/about/forms/formadv-part2.pdf.
[38] SEC v. Capital Gains, *supra* note 12, at 191.

We would be pleased to respond to any inquiries you may have regarding our letter or our views on the Proposed Interpretation more generally. Please feel free to direct any inquiries to Brian Daly or Marc Elovitz at [redacted].

Very truly yours,

SCHULTE ROTH & ZABEL LLP