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Via Electronic Submission to: rules-comments@sec.gov

August 24, 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 on behalf of the Hedge Funds Subcommittee (the "Subcommittee" or "we") of the Federal Regulation of Securities Committee (the "Committee") of the Business Law Section (the "Section") of the American Bar Association (the "ABA"), in response to the request for comments by the U.S. Securities and Exchange Commission (the "Commission" or "SEC") regarding its proposed interpretation regarding investment advisers' standard of conduct that is set forth in Investment Advisers Act Release No. 4889 (Apr. 18, 2018) (the "Proposed Interpretation"). The comments expressed in this letter represent the views of the Subcommittee only and have not been approved by the ABA's House of Delegates or Board of Governors, and, therefore, do not represent the official position of the ABA. In addition, this letter does not represent the official position of the Section.

BACKGROUND

On April 18, 2018, the Commission issued three proposals: the first addressing standards of conduct for broker-dealers when they deal with retail customers; the second setting out disclosures intended to help retail investors understand the key differences between investment advisers and broker-dealers; and the third elaborating on the fiduciary duty of investment advisers. Regarding the fiduciary duty of investment advisers, the Commission stated in the Proposed Interpretation that in light of the comprehensive nature of its proposed set of rulemakings, "it would be appropriate and beneficial to address in one release and reaffirm – and in some cases clarify – certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the [Investment Advisers Act of 1940]" (the "Advisers Act"). The Commission's goal underlying the Proposed Interpretation is to highlight the principles relevant to an adviser's fiduciary duty. The Commission has indicated that it does not intend the Proposed Interpretation to be the exclusive resource for understanding an investment adviser's fiduciary duty. We acknowledge and agree that the Commission is the agency best positioned by experience and expertise to provide a comprehensive overview of this very important topic. We

appreciate this opportunity to provide our comments regarding the Proposed Interpretation.

EXECUTIVE SUMMARY

In this letter we address several concerns that we have regarding certain statements in the Proposed Interpretation and we respectfully request the following changes to the Proposed Interpretation:

1. The Commission should consider revising the discussion of an investment adviser's fiduciary duty to recognize that the content of this duty must be viewed in the context of the particular relationship between and investment adviser and its client.

2. The Proposed Interpretation should be modified to say that an investment adviser cannot, through the means of a blanket waiver of all conflicts or when using disclosure that is not reasonably designed to be full and fair to the client, disclose or negotiate away, and the client cannot waive, the federal fiduciary duty.

3. The Commission should revise the Proposed Interpretation to reflect that sophisticated investors are presumed to understand an investment adviser's conflicts of interest when they are given full and fair disclosure, and be deemed to have given informed consent on that basis.

4. The Proposed Interpretation should be amended to reflect that, when addressing a conflict of interest, an investment adviser may obtain informed consent from its client through full and fair disclosure, and only if informed consent is unavailable must an investment adviser avoid the conflict of interest.

DISCUSSION

The Proposed Interpretation states that that the Advisers Act establishes a federal fiduciary standard for investment advisers and that this fiduciary standard is "based on equitable common law principles and is fundamental to advisers' relationships with their clients under the Advisers Act."[1] As the Commission notes, the fiduciary duty of investment advisers is not specifically defined in the Advisers Act or in the rules thereunder. Rather, it reflects Congress' 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 which was not disinterested."[2]

We agree with the Commission that investment advisers are fiduciaries under common law, and that while the Advisers Act does not refer to investment advisers as fiduciaries and does not define their duties as fiduciaries, the Act reflects Congress's recognition of the fiduciary nature of the relationship between an investment adviser and its client. However, we are concerned about a number of statements in the Proposed Interpretation about the nature of the fiduciary duty owed by investment advisers to their clients. Certain of these statements, we believe, are not supported by the law or could be read as prohibiting business practices that have never been identified as outside of the scope of the Advisers Act and that have been commonly disclosed by investment advisers and consented to by clients.

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[1] Investment Advisers Act Release No. 4889 (Apr. 18, 2018) at 6 (the "Proposed Interpretation").
[2] *Id.* (quoting *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963) ("*Capital Gains*")).

Investment Adviser as Agent. We note at the outset that it is difficult to capture the nature of an investment adviser's fiduciary duty in a broad statement that has universal applicability. The concept of fiduciary duty, as the Proposed Interpretation notes in several places, draws in part from the law of agency. Characterizing an investment adviser as the agent of the client principal, as does the Proposed Interpretation, does not, however, answer the question of how to apply the duty of care or the duty of loyalty to the particular relationship between an investment adviser and a client.

Many types of principal-agent relationships have been recognized in the common law, and the duties implied in those relationships may differ substantially. The Commission itself acknowledged this point when proposing Regulation Best Interest under the Securities Exchange Act of 1934 ("Exchange Act").[3] In that proposal, the Commission noted that a broker-dealer and a customer have a principal-agent relationship, but proposed an entirely different standard of conduct for broker-dealers toward their retail customers.[4] The Commission noted further in the proposal that under the anti-fraud provisions of the Exchange Act, "a broker-dealer's duty to disclose material information to its customer is based upon the scope of the relationship with the customer, which is fact intensive."[5] The Commission went on to indicate that the material information that a broker-dealer must disclose to a customer will differ depending on the scope of services provided by the broker-dealer, such as whether or not the broker-dealer is recommending a security.[6] The courts have recognized that the duties owed by an agent to a principal can change over a period of time, depending on the circumstances.[7]

The scope of services provided by an investment adviser to clients may, likewise, vary considerably, and the duties owed by the adviser to different clients may not be identical.[8] We respectfully request that the Commission address this point by revising the discussion of an investment adviser's fiduciary duty to recognize that the content of this duty must be viewed in the context of the particular relationship between an investment adviser and a client.[9]

Ability to Define Scope of Relationship by Contract. We find troubling the broad statement in the Proposed Interpretation that an investment adviser "cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty. "[10] This statement was not supported in the Proposed Interpretation by any citation to case law, and we are unaware of any cases that are a basis for the statement.

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[3] The Commission recognized this on page 8 of the Proposed Interpretation, when it said that "the ability to tailor the terms [of the relationship by contract] means that the application of the fiduciary duty will vary with the terms of the relationship . . . ."

[4] *See* Regulation Best Interest, Exchange Act Release No. 83062 (Apr. 18, 2018), at 7, 15, 22, 48, available at https://www.sec.gov/rules/proposed/2018/34-83062.pdf (describing the relationship between a broker-dealer and a customer as a principal-agent relationship).

[5] *Id.* at n. 176 (citing *Conway v. Icahn & Co., Inc.,* 16 F. 3d 504, 510 (2d Cir. 1994)).

[6] *See id.* (citing *Hanly v. SEC,* 415 F.2d, 589, 597 (2d Cir. 1969)).

[7] *See, e.g., Hecht v. Harris, Upham & Co.,* 430 F. 2d 1202 (9th Cir. 1970) (broker who traded excessively after assuming control of non-discretionary account owed customer additional duties); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 461 F. Supp. 951 (E.D. Mich. 1978) (finding that broker had not assumed control over a non-discretionary account, owed only those duties applicable to nondiscretionary accounts).

[8] *See supra* note 3.

[9] This context could also include the type of client receiving investment advice. For example, trustees that are clients of investment advisers have fiduciary duties of their own to their trusts, which may be applicable in establishing the scope of services and duties pertaining to the advisory relationship as set out by contract between the adviser and the trustees.

[10] Proposed Interpretation at 8.

The statement that an adviser cannot disclose or negotiate away its fiduciary duty was preceded by the following statement:

> The duty [the federal fiduciary duty] follows the contours of the relationship of the adviser and its client, and **the adviser and its clients may shape that relationship through contract when the client receives full and fair disclosure and provides informed consent**.[11]

Add to this the statement that "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," and we are concerned that the Proposed Interpretation will cause unnecessary confusion as to the ability of an investment adviser and client to define the scope of the adviser's services and duties, an ability long recognized in fiduciary law.[12] Particularly when an investment adviser is dealing with a sophisticated client, such as an institutional investor or an investor who is, for example, an "accredited investor,"[13] we believe that the adviser and client should be able to define the scope of the adviser's services and duties by contract when the client is given full and fair disclosure and gives informed consent.

The notion that disclosure and informed consent may not be enough to address certain conflicts of interest faced by investment advisers is not only unsupported by the common law, it is also inconsistent with the realities of the marketplace. Investment advisers, like other professionals, often engage in practices that present potential conflicts of interest or otherwise could be deemed to be inconsistent with their fiduciary duty. In such cases, an adviser, on the basis of acknowledged common law principles, discloses the potential conflict clearly and clients consent to proceeding, either by the terms of their investment advisory contracts or otherwise.[14] Examples of these practices include client-directed brokerage, trade aggregation and allocation, and using client brokerage commissions to pay for research. In each case, the adviser arguably "discloses or negotiates away" and the client "waives" a part of the federal fiduciary duty. However, in none of these cases does the adviser disclose or negotiate away, or the client waive, the adviser's duty to seek best execution for the client's transactions or the adviser's other duties as a fiduciary and, to our knowledge, neither the Commission nor the staff has objected to the practice.

To avoid confusion over the investment adviser's ability to enter into agreements defining the scope of the its services and duties based on full and fair disclosure and informed consent (which disclosures and consents often occur, except in the case of transactions subject to Section 206(3) of the Advisers Act, only at the outset of the relationship), we believe that the assertion in the Proposed Interpretation that an investment adviser "cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary duty" should be limited to situations involving a blanket waiver of all conflicts or the use of disclosure that is not reasonably designed to be full and fair to the client. We respectfully request that the Commission consider modifying the statement in the Proposed Interpretation accordingly.

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[11] *Id.* (emphasis added).
[12] In an often-cited administrative proceeding against a dual registrant that had entered into an advisory agreement with clients providing that transactions would be effected on a principal basis, the Commission made clear that the adviser and clients could agree to an arrangement that placed the adviser's interests in conflict with the clients' interests, so long as the client gives informed consent after receiving disclosure of all material facts as to the advisability of entering into the transaction. *See* Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948).
[13] *See* Rule 501(a) under the Securities Act of 1933 (the "1933 Act") (definition of "accredited investor").
[14] *See* Proposed Interpretation at 6.

Disclosure and Sophisticated Investors. We believe that it is appropriate, and consistent with an investment adviser's fiduciary duty to its clients, to require that conflicts of interest be fully and fairly disclosed. Indeed, that is the manner in which the law and industry practice have developed under the Advisers Act. The law and practice that has taken shape over time seems quite consistent with the words of the Supreme Court in SEC v. Capital Gains Research Bureau, in which the Court noted that "the evident purpose of the Investment Advisers Act of 1940 [was] to substitute a philosophy of disclosure for the philosophy of caveat emptor . . . ." The law and practice also flow from the Court's holding that the antifraud provisions of Section 206 of the Advisers Act include a proscription against failure to disclose material facts that the Commission is empowered to enforce.[15]

We are concerned that the Commission's statement in the Proposed Interpretation that certain conflicts of interest may be too complex or extensive to be adequately disclosed weakens the historical reliance on disclosure that is reflected in the Advisers Act.[16] We understand that the Commission may be particularly concerned about whether retail investors would understand certain disclosures. This concern would seem unwarranted with respect to institutional and other sophisticated investors when they have received full and fair disclosure.

The federal securities laws have long recognized that sophisticated investors can be presumed to understand the risks involved with complex transactions or with complex conflicts of interest when they have been given full and fair disclosure.[17] Sophisticated investors either have the experience and knowledge necessary to understand such disclosures, or they can avail themselves of sophisticated advisors to help them.

The interests in many funds not registered under the Investment Company Act of 1940 (the "1940 Act") are available for investment only by "qualified purchasers,"[18] pursuant to Section 3(c)(7) of the Act. The offering documents for such funds may disclose conflicts of interest involving the fund, its investment manager, or others to qualified purchasers, which are sophisticated investors whom the Commission judged not to need the full panoply of protections afforded under the 1940 Act. Moreover, many issuers issue securities in private offerings in reliance upon Regulation D under the Securities Act of 1933 ("1933 Act"), which recognizes that sophisticated investors, *e.g.,,* investors falling within the definition of "accredited investor," do not

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[15] *See Capital Gains,* 375 U.S. at 197-8.
[16] *See* Proposed Interpretation at 18-19.
[17] *See, e.g.,* Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Advisers Act Release No. 1731 (Jul. 15, 1998) (adopting amendments to Rule 205-3, noting that clients satisfying certain financial or sophistication criteria "do not need the full protections provided by the Advisers Act's restrictions on performance fee arrangements"); Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389 (Mar. 8, 1982) (adopting Regulation D, including definition of "accredited Investor" and Rule 506 sophistication standard for non-accredited investors) ("Release 6389").
[18] A "qualified purchaser" is defined in Section 2(a)(51) of the 1940 Act as a person or entity that falls within one of four categories of investors eligible to invest in a private fund under Section 3(c)(7). The SEC staff has noted that "[t]he exclusion provided by section 3(c)(7) reflects Congress' recognition that financially sophisticated investors are in a position to appreciate the risks associated with certain investment pools and do not need the protection of the 1940 Act." Cabot Wellington, LLC, SEC No-Action Letter (Jun. 17, 2008), n.7, available at https://www.sec.gov/divisions/investment/noaction/2008/cabot061708-3c7.pdf, *citing* S. Rep. No. 293, 104th Cong., 2d Sess. 10 (1996) ("Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.")

need the full protections of the 1933 Act, so long as they are given the disclosures required under that regulation.[19]

The different level of disclosure provided to accredited investors in transactions under Regulation D demonstrates that the Commission recognizes that such investors are able to understand and proceed on a basis different from retail investors. We respectfully request that the Commission acknowledge this principle in its interpretation of the fiduciary duty of investment advisers. Sophisticated investors should be presumed to understand an investment adviser's conflicts of interest when those investors are given disclosure reasonably designed to be full and fair and to be deemed able to give informed consent on that basis.

Disclose or Avoid Conflicts of Interest. We are concerned about the Proposed Interpretation's statement that "an adviser must seek to avoid conflicts with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship."[20] In our view, this articulation could be read as saying that an investment adviser must first seek to avoid a conflict of interest before the adviser can deal with the conflict through disclosure. Such a reading would be, in our view, inconsistent with common law precedents and the manner in which the industry has evolved.

We believe the law does not establish an obligation to seek to avoid all conflicts of interest; imposing such an obligation on investment advisers would, in our judgment, be unworkable, particularly in the context of hedge funds. It is in the nature of such pooled investment arrangements that conflicts will and do exist between an investment adviser and funds it manages. Many hedge fund managers, for example, advise more than one fund. The statement in the Proposed Interpretation that an investment adviser must seek to avoid conflicts would seem to indicate that a business model in which the investment adviser has more than one fund client is an arrangement the adviser should seek to avoid, as it may be argued that the

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[19] *See* Release 6389, supra note 17. Another example relevant to investment advisers is Rule 205-3 under the Advisers Act, which permits registered investment advisers to charge performance-based compensation to "qualified clients." In addition, the SEC staff has taken no-action positions regarding certain practices based on the sophistication of the client and the disclosures provided to such clients, including Heitman Capital Management (SEC No-Action Letter) (Feb. 12, 2007) (permitting the inclusion of a "hedge clause" in investment advisory contracts limiting an investment adviser's liability); Credit Suisse First Boston, LLC, SEC No-Action Letter (Aug. 31, 2005) (investment adviser permitted to rely on global consents, rather than trade-by-trade consents, for certain principal transactions); and Investment Company Institute, SEC No-Action Letter (Sept. 23, 1988) (use of gross performance results without showing net-of-fee results in marketing materials used in one-on-one presentations).

[20] Proposed Interpretation at 16. The Commission did not provide substantial support in the law for this statement in the Proposed Interpretation. In the Proposed Interpretation, the Commission cites *Capital Gains* in support of this statement, specifically noting "advisers must fully disclose all material conflicts, citing Congressional intent 'to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.'" Proposed Interpretation at 16 n.43. This discussion of the legislative history in *Capital Gains* appears to be mere dicta, as in *Capital Gains* the Court considered whether an investment adviser made appropriate disclosures to its client and the holding in that case did not establish any obligation to seek to avoid conflicts of interest. The Court expressly rejected arguments that the trading activity in question created a conflict that must be "eliminated," saying that the Commission sought only disclosure of the conflicts. *Capital Gains, supra* note 2, at 196. The Commission further cites Advisers Act Release 3060 ("Form ADV Instructions"), which contains instructions to Form ADV, in support of its statement. Proposed Interpretation at 16 n. 43. The language in the Form ADV Instructions is identical to the formulation in the Proposed Interpretation and the Form ADV Instructions do not cite any legal authority for this formulation, which was itself promulgated by the Commission. *See* Advisers Act Release No. 3060, at 1 (Jul. 28, 2010).

adviser benefits financially by having more than one fund client and the duties that the adviser owes to each fund client could conflict.

Investment advisers that manage hedge funds routinely make disclosures, in Form ADV and in fund offering documents, among other places, about the conflicts of interest that arise from their advisory business. An investment manager advising more than one fund will face conflicts of interest resulting from, for example, differences in fund fee structures, liquidity features, and investment and trading strategies, as well as from investments in illiquid investments, investments in different parts of an issuer's capital structure, trade aggregation and allocation decisions, proprietary investments by the adviser or its personnel (either investing in a fund or otherwise), and differences in how two funds may use leverage, among others. If an investment adviser were required, to avoid conflicts, first, and turn to disclosure only if the conflict could not be avoided, it would seem impossible for the adviser to manage multiple funds.

We believe that, under acknowledged legal principles, an investment adviser satisfies its fiduciary duty by making full and fair disclosure of material conflicts, and if it cannot do so, then it must seek to avoid the conflicts. In our view, a reading of the Proposed Interpretation to say that the responsibility of the adviser to seek to avoid conflicts, and then, if it cannot avoid the conflicts, "at a minimum" disclose those conflicts, is at odds with the manner in which the investment management business has developed. We respectfully request that the Commission clarify this articulation in the Proposed Interpretation by stating that an investment adviser satisfies its duty by making full and fair disclosure of all material conflicts of interest that could affect the advisory relationship, and if it cannot do so, it must seek to avoid such conflicts.

Suggested Areas for Enhancement of Regulations. In the absence of proposed rules, we are not commenting at this time about the Commission's suggestions for possible regulatory action on the topics of licensing and continuing education, account statements and financial responsibility. In our view, the need for such additional regulation has not been demonstrated, particularly with respect to private fund clients and other sophisticated clients, nor have we seen a cost/benefit analysis with respect to such enhanced regulation. We note that hedge fund managers almost universally do not have physical possession of fund assets, which are typically maintained at qualified custodians. It is unclear to us how harmonization of the regulation of investment advisers with broker-dealer regulations aimed at protecting retail customers will benefit investment advisers' fund clients and other sophisticated clients.

CONCLUSION

The Subcommittee appreciates the opportunity to comment on the Proposed Interpretation and respectfully requests that the Commission consider the comments and recommendations set out above. Members of the Subcommittee are available to discuss these comments should the Commission or the staff so desire.

Very truly yours,

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