Money Management Institute

August 7, 2018

Submitted electronically through http://www.regulations.gov

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Regulation Best Interest [File Number S7-07-18];

Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles [File Number S7-08-18]; and

Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation [File Number S7-09-18]

Dear Mr. Fields:

The Money Management Institute ("MMI") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("Commission") on its proposed package of regulations and interpretations on the standards of conduct that apply to the provision of advice to retail investors.[1]

MMI is the national organization for the advisory solutions industry, representing a broad spectrum of investment advisers that manage separate accounts, as well as sponsors of investment consulting programs. MMI was organized in 1997 to serve as a forum for the industry's leaders to address common concerns, discuss industry issues, and work together to better serve investors. Our membership is comprised of firms that offer comprehensive financial consulting services to individual investors, foundations, retirement plans, and trusts; related professional portfolio management firms;

[1] *Regulation Best Interest*, 83 Fed. Reg. 21574 (May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08582.pdf ("Regulation BI Proposal"); *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, 83 Fed. Reg. 21203 (May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08679.pdf ("Proposed Interpretation"); Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the use of Certain Names or Titles, 83 Fed. Reg. 21416 (May 9, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-05-09/pdf/2018-08583.pdf ("Disclosure Proposal", together with the Regulation BI Proposal and Proposed Interpretation, collectively referred to as the "Proposals").

and firms that provide long-term services to sponsor, manager, and vendor firms. MMI is a leader for the advisory solutions industry on regulatory and legislative issues.

We thank the Commission and its staff ("Staff") for taking the initiative to lead on this issue. The various separate efforts to address the standards of conduct for broker-dealers and investment advisers has engendered concern within the industry and contributed to confusion within the investing public, and we believe that the Commission's proposed standards of conduct are a significant step in the right direction. In this regard, we applaud the Commission's efforts to publish rulemaking and interpretive guidance designed to address investor confusion, clarify the standards of conduct and enhance existing protections for retail investors. MMI shares the Commission's goals of enhancing the quality and transparency of investors' relationships with advice providers, while preserving access to a variety of types of advice relationships and investment products. We and our members are committed to working with the Commission to develop final conduct standards that meet these important goals.

To that end, while we are generally supportive of the Commission's efforts, we have some concerns about certain ambiguities in the proposals that would complicate our shared goal of clarifying the standards that apply in brokerage and advisory relationships. We have therefore highlighted the following considerations and recommended certain adjustments to the Proposals that we believe will enhance their effectiveness and applicability while still achieving the Commission's stated objectives.

I. *Regulation Best Interest*

We commend the Commission for embracing an enhanced standard of conduct for broker-dealers that builds upon existing broker-dealer suitability concepts, as well as the requirements of the Securities Exchange Act of 1934 and the FINRA rules. However, there are certain ambiguities in the core concepts that comprise Regulation Best Interest ("Regulation BI") that we urge the Commission to clarify, as set forth below.

A. *The Best Interest Standard is Not Clearly Defined*

As proposed, Regulation BI would require broker-dealers and their associated persons to act in the best interest of retail customers when making a recommendation of any securities transaction or investment strategy involving securities, without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer. Regulation BI would impose three separate obligations to meet this standard: (i) a duty of disclosure, where the broker-dealer reasonably discloses to the retail customer, in writing and prior to or at the time of the recommendation, the material facts relating to the scope and terms of the relationship with the retail customer, and all material conflicts of interest associated with the recommendation; (ii) a duty of care, where the broker-dealer exercises reasonable diligence, care, skill and prudence when making recommendations, including having a reasonable basis to believe that recommendations are in a customer's best interest; and (iii) a duty to establish, maintain, and enforce written policies and procedures around conflicts of interest.[2]

[2] *See generally* Regulation BI Proposal*;* 17 C.F.R. § 240.15l-1(a)(1).

As an initial matter, the "best interest" standard is vague, and is likely to engender confusion among broker-dealers regarding the analysis of their agency and fiduciary duties to clients. Although Regulation BI includes a set of criteria designed to assist broker-dealers in determining whether they have satisfied the conduct standard, the proposal does not define the term "best interest," and the underlying conditions designed to meet the standard themselves use the term "best interest."

Consequently, it will be difficult for regulated entities to determine what will be required to have a "reasonable basis" that a recommendation is in a client's best interest. Moreover, as discussed in more detail below, the "best interest" concept proposed in Regulation BI conflates existing fiduciary common law duties of loyalty and care. Absent clarification and further guidance, the ambiguities around the definition and application of the "best interest" concept will impede the ability of broker-dealers to analyze and meaningfully apply these duties to their business models and retail investor service lines. We acknowledge that the Commission does state in the proposing release that it would interpret "best interest" "to require the broker-dealer not put its own interest ahead of the retail customer's interest,"[3] but that concept is not reflected in the proposed rule. We request that the Commission eliminate the ambiguity regarding the "best interest" standard by codifying its interpretation within Regulation Best Interest itself.

B. *Application of Conduct Standards to Account Recommendations*

The Commission proposes that Regulation BI apply not just to recommendations of any securities transaction (sale, purchase, and exchange), but also to the recommendation of an investment strategy involving securities to a retail customer.[4] Regulation BI makes clear that the "best interest" obligation also attaches to the recommendation of particular account types that are "tied to a securities transaction (e.g., to roll over or transfer assets such as IRA rollovers)."[5] Applying Regulation BI to the recommendation of account types that are "tied to a securities transaction" is ambiguous given that all advisory or brokerage accounts are inherently opened for the purpose of engaging in securities transactions, whether through the liquidation of existing securities, the purchase of new securities or some combination of the two. This is especially so with recommendations to retail customers regarding advisory accounts, where securities transactions can be expected to occur following account inception.

Further, we question why Regulation BI should apply to prospective clients in connection with the selection of a particular account type at all. Rather, Regulation BI should reflect common law concepts that an agent, or fiduciary for that matter, does not owe responsibilities to a prospective customer relating to the suitability of the terms of the proposed arrangement between the agent or fiduciary and its client.

It is well-settled that a fiduciary does not owe fiduciary duties to a potential client before the parties have agreed on the nature and scope of the services to be provided. The common law defining the contours of fiduciary duty establishes obligations in the management of client accounts (i.e., the

[3] *Id.* at 21586.

[4] *Id.* at 21681.

[5] *Id.* at 21595.

substance of investment advice or recommendations), but does not apply to the determination of whether a fiduciary relationship is appropriate or should continue. Common law fiduciary principles do not recognize an obligation to determine whether an investment advisory program or brokerage relationship is suitable for a client or prospective client, and no such duty is reflected in the Restatements of the Laws of Trusts or Agency, even though they are the primary compendia of the law governing fiduciaries. Rather, common law principles establish that, "[p]rior to the commencement of an agent's fiduciary relationship with a principal, and following termination of the relationship, the prospective or erstwhile agent is not subject to an agent's fiduciary duties in dealing with the principal."[6] For instance, an investment adviser does not owe fiduciary duties to a potential client before the parties—bargaining at arm's length—have agreed on the scope and boundaries of their proposed relationship (i.e., the extent of the adviser's authority and the client's reliance on the adviser).[7] It is well established that a party does not act as a fiduciary with respect to the negotiation of the terms in an agreement if it does not control the negotiation and approval of those terms.[8] Once a fiduciary relationship is established, however, an agent has additional fiduciary obligations that correspond to the scope and nature of that relationship.[9]

Applied to this context, we do not think that Regulation BI should contravene the fiduciary law on which the proposals are based by imposing a suitability obligation on broker-dealers to act in a prospective client's best interest when recommending and negotiating account types. We further believe that this position, and the arguments referenced above, should apply to the Commission's interpretation of an investment adviser's suitability obligations in the Proposed Interpretation.

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[6] *See Restatement (Third) of Agency* § 8.01, cmt. c.

[7] *See* Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers: Mutual Funds and Advisers § 11.01 [hereinafter "Frankel & Schwing"] ("Toward "prospective clients," advisers have a duty to disclose all material facts in connection with the offer of their services. . . . Toward clients, advisers must, in addition, honor fiduciary obligations.") (footnote omitted).

[8] *See Renfro v. Unisys Corp.*, 671 F.3d 314, 324 (3d Cir. 2011) ("[A] party 'does not act as a fiduciary with respect to the terms in the service agreement if it does not control the named fiduciary's negotiation and approval of those terms.'" (quoting *Hecker v. Deere & Co.*, 556 F.3d 575, 583 (7th Cir. 2009)); *see also McCaffree Fin. Corp. v. Principal Life Ins. Co.*, No. 15-1007 (8th Cir. 2016) (agreeing with *Hecker* and *Renfro* that "a service provider's adherence to its agreement with a plan administrator does not implicate any fiduciary duty where the parties negotiated and agreed to the terms of that agreement in an arm's-length bargaining process"); *F.H. Krear & Co. v. Nineteen Named Trs.*, 810 F.2d 1250, 1259 (2d Cir. 1987). *But see Staff of the Securities and Exchange Commission, Study on Investment Advisers and Broker Dealers at 22* (Jan. 2011) ("Under the Advisers Act, an adviser is a fiduciary. This fiduciary standard applies to the investment adviser's entire relationship with its clients and prospective clients . . . .").

[9] *See generally Frankel & Schwing, supra* note 7, at § 11.01. *Cf.* Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 819 n.75 (1983) ("If the fiduciary bargains with the entrustor *before* the relation is established, the bargain is presumed to be at arm's length. If an agreement for benefit to the fiduciary is made *after* the fiduciary relation is established, however, the likelihood is greater that the entrustor relied on the fiduciary. Fiduciary law protects the entrustor by obligating the fiduciary to disclose all material facts, requiring an intelligent, independent consent from the entrustor, a substantively fair arrangement, or both. If the beneficiary is unable to give such informed consent, courts may review the arrangement.").

C. *Mitigation of Conflicts of Interest*

Regulation BI requires broker-dealers to either disclose *and* mitigate, or in certain cases completely eliminate, material conflicts of interests arising from financial incentives associated with recommendations to retail customers.[10] The Commission's proposal aims to provide broker-dealers with flexibility to establish policies and procedures that include conflict mitigation measures tailored to each firm's circumstances.

We urge the Commission to provide guidance from which firms can draw a reasonable distinction between the types of material conflicts arising from financial incentives that may be disclosed and mitigated, and those that, in the Commission's view, must be eliminated. The only financial incentive conflict that the Commission points to in Regulation BI as a conflict of interest that is more appropriately eliminated is the receipt of non-cash compensation in connection with "sales contests, trips, prizes, and other similar bonuses that are based on sales of certain securities or accumulation of assets under management." It is not clear why the Commission views sales contests or other bonuses tied to the accumulation of assets under management as a material conflict where eligibility is not based on the sale of particular products or is otherwise impartial with respect to products. In this regard, we note that FINRA rules approved by the Commission permit broker-dealers and their associated persons to participate in sales contests and other internal firm non-cash compensation arrangements that are based on total production and equal weighting of product sales.[11]

We further urge the Commission to clarify that the requirement to eliminate material conflicts arising from financial incentives applies only to those material conflicts that may affect the nature of the advice that an associated person of a broker-dealer provides to retail customers, and not to financial incentives that arise at the firm level and are inherent in the operation of the broker-dealer itself. To do this, the Commission could replace the conflicts of interest obligation with a requirement that broker-dealers establish policies and procedures that are reasonably designed to satisfy the disclosure and care obligations of Regulation BI, and that are reasonably designed to mitigate material conflicts arising from financial incentives provided to a natural person that is an associated person of a broker-dealer. In defining the types of financial incentives that create material conflicts of interest, the Commission could look to those specified in Form ADV, Part 2B.

Additionally, Regulation BI does not set forth any criteria or meaningful factors to distinguish between material conflicts arising from financial incentives that can be addressed through disclosure and mitigation, and those that are more appropriately eliminated. In order to provide regulatory predictability for firms when they are assessing their conflict management practices, we recommend that the Commission provide clear guidance on the types of financial incentives that create a material conflict that must be eliminated. Similarly, we also do not find it clear in Regulation BI how firms would distinguish between material conflicts that arise from financial incentives, which comprise the vast majority of conflicts in the financial services industry, and those that do not arise from a financial incentive, and request additional clarity on how to make this distinction. If the Commission similarly

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[10] Regulation BI Proposal *at* 21620.

[11] *See* FINRA Rule 2320(g)(4)(D).

finds that it cannot distinguish between the two, we urge the Commission not to draw a distinction between financial incentive and other conflicts.

Further, there is considerable ambiguity in Regulation BI around what it means to effectively "mitigate" a conflict and what standards, if any, the Commission or its Staff will apply (or expect broker-dealers to apply) to assess whether a conflict has been sufficiently "mitigated". In our view, mitigation should be defined not in terms of any specific outcome, but by the process through which a broker-dealer manages or addresses the conflict. For example, with respect to proprietary products, firms might consider whether there are ways to mitigate financial incentives to favor proprietary products over others. In this regard, we note that removing the "mitigation" requirement at the firm level for broker-dealers, and allowing firms to address a preference for proprietary products through disclosure to retail customers, would provide considerable clarity to the industry and would have the effect of leveling the regulatory playing field between advisory and brokerage services.

II. *Investment Advisers Act Interpretation*

We appreciate that in reconsidering the regulatory framework that applies to the provision of advice to retail investors, it is important to consider both the broker-dealer and the investment adviser standards of conduct. In approaching the Proposed Interpretation, however, we hope the Commission is cognizant of the fact that any restatement or clarification of existing standards will have broad implications far beyond advice provided to retail investors. Unlike Regulation BI, which can be narrowly tailored to apply only to retail investors, investment advisers owe fiduciary duties to all of their clients, regardless of whether they are retail investors. Accordingly, the Proposed Interpretation will affect investment advisers that provide advice to institutional investors – such as private funds, investment companies, endowments and foundations – as well as retail investors.

Given the importance of protecting the retail investing public and the broad application of the Proposed Interpretation, it is important that the proposed guidance accurately reflect both the common law principles that form the basis of the federal fiduciary standard under the Investment Advisers Act of 1940 ("Advisers Act"), and the present realities of how investment advisers provide advice under different arrangements. Therefore, we urge the Commission to revise the interpretation so that it reflects the common law principles in which an investment adviser's fiduciary duty is grounded.

We also note that the Commission states in the Proposed Interpretation that an investment adviser's fiduciary duty is enforceable under Section 206 broadly. We urge the Commission to revise these statements in a final interpretation, as they are imprecise. An investment adviser's fiduciary duty was established under, and is enforceable under, Sections 206(1) and (2).[12] To the extent the Proposed Interpretation seeks to impose obligations on investment advisers beyond those that constitute fraud under common law, the Commission can only do so under the rulemaking authority conferred on the Commission by Section 206(4). This is because the Commission's interpretations under Sections 206(1) and (2) are limited to existing common law concepts of fiduciary duty. Courts have rejected

[12] *See Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

Commission attempts to define fraud more broadly for purposes of Sections 206(1) and (2).[13] Indeed, Congress has recognized that Sections 206(1) and (2) are limited to common law principles and, in 1960, added Section 206(4) to the Advisers Act to address the limitations of Sections 206(1) and (2).[14]

For example, the Commission appears to suggest that investment advisers, as fiduciaries, are required to act in the best interest of their clients, and that the duties of loyalty and care flow from that overarching best interest obligation. Specifically, the first sentence of the "Introduction" to the Proposed Interpretation states: "An investment adviser is a fiduciary, and as such is held to the highest standard of conduct and must act in the best interest of its clients."[15] This, however, is an imprecise formulation of an investment's fiduciary duty that departs from settled law. The common law reflects a "best interest" concept only in the context of the duty of loyalty, under which a fiduciary may benefit from a transaction provided the principle has given informed consent.[16] Moreover, the only prior references that the Commission has made to an investment adviser's obligation to act in the best interest of its clients relates to an investment adviser's duty of loyalty, rather than the duty of care.[17] Accordingly, we believe that the inclusion of the best interest standard is misplaced in that it should not be part of the duty of care at all, but rather should be limited to its proper role as an articulation of the existing duty of loyalty. Layering the "best interest" terminology into the Proposed Interpretation does little to help clarify existing concepts around an investment adviser's fiduciary

[13] *See, e.g., United States v. Elliott,* 62 F.3d 1304, 1311 (11th Cir. 1995) ("[C]ongress's primary concern appeared to be the possible limitations imposed by common-law concepts of fraud and deceit"); *Goldstein v. Securities & Exchange Commission,* 451 F.3d 873 (D.C. Cir. 2006) (distinguishing Section 206(1) and (2) from section 206(4) of the Advisers Act); *SEC v. Blavin,* 557 F. Supp 1304 (E.D. Michigan, Mar. 1, 1983).

[14] *See* Act of Sept. 13, 1960, Pub. L. No. 86-750, 74 Stat. 885 at § 9 (codified as amended at 15 U.S.C. §§ 80b-2–80b-6, 80b-8–80b-12, 80b-17); H.R. Rep. No. 2179, 86th Cong., 2d Sess., at 7–8 (1960) ("Because of the general language of section 206 and the absence of express rulemaking power in that section, there has always been a question as to the scope of the fraudulent and deceptive activities which are prohibited and the extent to which the Commission is limited in this area by common law concepts of fraud."); *see also Capital Gains*, *supra* note 12 *at* 191.

[15] Proposed Interpretation at 21204.

[16] *See Restatement (Third) of Agency* § 8.06 (allowing a principal to consent to conduct by an agent that would violate its duties owed to the principal, provided that "the agent (i) acts in good faith, (ii) discloses all material facts that the agent knows, has reason to know, or should know reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal"); *id.* § 8.03 cmt. b (stating that to the extent that the agreement between the agent and principal permits the agent to engage in self-dealing, "the agent is subject to a contract-law duty of good faith and fair dealing in exercising the discretion").

[17] Prior to the Proposed Interpretation, the Staff had only addressed an investment adviser's obligation to act in the "best interests" of clients as it relates to an adviser's duty of loyalty when voting proxies. *See* Amendments to Form ADV, Investment Advisers Act Rel. No. 3060 (July 28, 2010) [hereinafter, "Form ADV Adopting Release"] at text accompanying FN 3 (citing Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106, 68 Fed. Reg. 6585 (Jan. 31, 2003) [hereinafter "Proxy Voting Release"] ("To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own."))

duty. Rather, it has the unintended effect of resulting in a formulation of fiduciary duty that is inconsistent with, and not a faithful articulation of, prior Staff guidance and common law precedent.

As a more general matter, we note that, with the exception of the reference to the Supreme Court's opinion in *Capital Gains*, the Proposed Interpretation articulates various Staff positions as settled matters of law, and cites to Commission and Staff precedent, without citation to the common law precedent informing the settled body of law that the Proposed Interpretation would upend.[18] Indeed, the range and depth of disclosure that the Commission proposes to require would go well beyond what is currently contemplated by existing precedent, Staff interpretive guidance for Sections 206(1) and (2) and the common law. Accordingly, we request that the Commission conform the Proposed Interpretation to the existing contours of the fiduciary duty. This has the advantage of being both consistent with the common law and precedent, and not inhibiting or superseding the development of common law in a way that could eliminate its precedential authority or obstruct its application in future court proceedings. If the Commission wishes to impose a best interest standard of conduct on investment advisers that would have the effect of re-formulating the fiduciary duties an investment adviser owes under common law, it may do so through the rulemaking process under Sections 206(4) or 211(g).

A. *Articulated Limits on Disclosure Depart from Common Law*

The existing regulatory framework governing investment advisers is a disclosure-based regime, under which investment advisers are not prohibited from providing services or taking action where there is a conflict provided that full and fair disclosure of all material facts about the conflict is made to clients.[19] In a significant departure from the Supreme Court's well-established interpretation of the federal fiduciary standard for investment advisers and prior Commission and Staff guidance, the Proposed Interpretation asserts the principle that there are certain conflicts that cannot be addressed through disclosure.[20] This principle is contrary to the common law foundations of the fiduciary duty of loyalty, as well as federal securities case law and Commission precedent.

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[18] Speech of Commission Hester M. Pierce, "What's in a Name? Regulation Best Interest v. Fiduciary," (Jul. 24, 2018), accessible at https://www.sec.gov/news/speech/speech-peirce-072418 ("In fact, I take issue with one important aspect of the proposed interpretation of an adviser's fiduciary duty. The Commission states that the duty of loyalty component of an adviser's fiduciary duty requires the adviser to acquire "informed consent" from its clients to any material conflict of interest that could affect the advisory relationship. However, as authority for this position the Commission cites, not a court decision or other weighty legal precedent, but an Instruction to Form ADV.")

[19] *See* Form ADV Adopting Release, *supra* note 17 ("An investment 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." (citations omitted)); *Capital Gains, supra* note 12 at 191(stating that investment advisers, as fiduciaries, have an affirmative duty of utmost good faith, and "full and fair disclosure of all material facts").

[20] Proposed Interpretation at 21208, text accompanying FN 44.

An investment adviser's fiduciary duty comprises a duty of loyalty and a duty of care.[21] Under the duty of loyalty, an investment adviser is obligated to deal fairly with clients, seek to avoid conflicts of interest, disclose all material facts about conflicts of interest that exist, and not subrogate the clients' interests to its own without obtaining the client's consent.[22] A violation of Sections 206(1) and (2) may be based on an affirmative misrepresentation or the failure to disclose material facts where there is a duty to disclose such information.[23] Consistent with the common law, investment advisers are required to disclose all facts about material conflicts of interest and obtain informed client consent prior to acting on those conflicts.[24]

The Proposed Interpretation is a significant departure from this well-established precedent and from fundamental common law principles. While the Proposed Interpretation would reinforce that an adviser's obligations will vary among clients based on the contours of a particular advisory relationship and as agreed upon with the client by contract, the Commission stated that an adviser "must, at all times, serve the best interest of its clients and not subordinate its' clients interest to its own" and "cannot disclose or negotiate away, and the investor cannot waive, the federal fiduciary

[21] *Id.* at 21205; *see also* Proxy Voting Release, *supra* note 17 at text accompanying FN 2("Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf").

[22] *See* Form ADV Adopting Release, *supra* note 17 at p. 3 ("An investment 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.") (citations omitted); *see, e.g.*, *In re Mark F. Spangler*, Admin. Proceeding File No. 3-15868, 2014 SEC LEXIS 2197 (June 24, 2014) (barring from the industry an investment adviser that was convicted of wire fraud, money laundering, and investment adviser fraud for having, among other things, concealed that he diverted investors' funds to two privately held companies that he managed); *In re Martin Currie Inc. & Martin Currie Inv. Mgmt. Ltd.*, Investment Advisers Act Release No. 3404 (May 10, 2012) (sanctioning investment adviser for using client assets to purchase convertible bonds for the purpose of allowing another client to redeem securities from the same issuer without appropriate disclosure); *In re Feeley & Willcox Asset Mgmt. Corp. & Michael J. Feeley*, Investment Advisers Act Release No. 2143 (July 10, 2003) (sanctioning adviser for investing client assets in a debt instrument issued by an affiliated entity without proper disclosure).

[23] Information is material where there is a substantial likelihood that a reasonable investor would have considered the information important. *See S.E.C. v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992). *See* Form ADV Adopting Release, *supra* note 17 (stating that the standard of materiality under the Advisers Act is whether there is a substantial likelihood that a reasonable investor (here, client) would have considered the information important). *See S.E.C. v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992). *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988); *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 445, 449 (1976). This is a facts and circumstances test, requiring an assessment of the "total mix of information," in the characterization of the Supreme Court. *TSC Industries*, 426 U.S. at 449.

[24] *See* Frankel, *Fiduciary Law*, *supra* note 9, 71 CALIF. L. REV. at 824 n.98 ("A trustee may not self-deal with the trust property, except with the informed and independent consent of the beneficiary.") (citation omitted); *See Restatement (Third) of Agency* §§ 8.06, 8.03 cmt. B, *supra* note 16; *see also In re Banc of Am. Inv. Servs., Inc. & Columbia Mgmt. Advisors, LLC,* Investment Advisers Act Release No. 2733 (May 1, 2008) (sanctioning adviser for failing to disclose a conflict of interest); *Michael Flanagan*, Administrative Proceeding File No. 3-9784, 2000 SEC LEXIS 123 (Jan. 31, 2000) (initial decision) (stating that an investment adviser "owes its clients 'an affirmative duty of good faith, and full and fair disclosure of all material facts'") (quoting *Capital Gains*, *supra* note 12 at 194); *In re Account Mgmt. Corp.*, Investment Advisers Act Release No. 1529 (Sept. 29, 1995) (sanctioning investment adviser for failing to disclose its allocation policies to its clients in breach of its duty of loyalty as a fiduciary).

duty."[25] This is an incomplete and inaccurate statement of the law. Under the common law and Supreme Court interpretations of the Advisers Act, an investment adviser may rely on disclosure and informed consent to address a conflict that implicates the duty of loyalty.

General fiduciary principles provide that an agent has a fiduciary duty to act loyally for the principal's benefit,[26] which requires that the agent place the principal's interests ahead of its own.[27] Although an agent is generally prohibited from using its position to acquire a material benefit from a third party[28] and from engaging in self-dealing,[29] it may do so with the principal's informed consent. In obtaining the principal's consent to conduct that would otherwise violate an agent's duties to the principal, the agent must act in good faith, disclose all material facts that may influence the principal's decision, and deal fairly with the principal.[30] Accordingly, the agent must "disclose adverse interests to the principal so that the principal may evaluate, as only the principal is situated to do, how best to protect its interests in light of the agent's interest."[31]

The Supreme Court's decision in *Capital Gains*, which the Commission cites extensively in the Proposed Interpretation, affirms the principle that Sections 206(1) and (2) of the Advisers Act establish a disclosure-based federal fiduciary standard as a means to address conflicts.[32] In reaching its decision, the Supreme Court focused on the fundamental purpose of the federal securities laws "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry," as well as "'the delicate fiduciary nature of an investment advisory relationship.'"[33] The Court further noted that the Advisers Act reflects "a congressional intent to eliminate, *or at least expose*, all conflicts of interest which might incline an

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[25] Proposed Interpretation at 21205.

[26] *See* Restatement (Third) of Agency § 8.01 ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship.").

[27] *See id.* § 8.01, cmt. b ("Although an agent's interests are often concurrent with those of the principal, the general fiduciary principle requires that the agent subordinate the agent's interest to those of the principal and place the principal's interests first as to matters connected with the agency relationship.").

[28] *See id.* § 8.02 ("An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position").

[29] *See id.* § 8.03 ("An agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship.").

[30] *See id.* § 8.06 (allowing a principal to consent to conduct by an agent that would violate its duties owed to the principal, provided that "the agent (i) acts in good faith, (ii) discloses all material facts that the agent knows, has reason to know, or should know reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them, and (iii) otherwise deals fairly with the principal").

[31] *See id.* § 8.03 cmt. b (stating that to the extent that the agreement between the agent and principal permits the agent to engage in self-dealing, "the agent is subject to a contract-law duty of good faith and fair dealing in exercising the discretion").

[32] *Capital Gains*, *supra* note 12 at 191.

[33] *Id.*

adviser—consciously or unconsciously [sic]—to render advice which was not disinterested."[34] Following a detailed analysis of the legislative history, the Supreme Court did not require that investment advisers avoid conflicts of interest, but rather required that they provide appropriate disclosure of conflicts of interest so that clients can evaluate the conflicts. "An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest.'"[35]

The Commission's regulation of investment advisers under Sections 206(1) and (2) since *Capital Gains* has similarly focused on an investment adviser's duty to disclose material facts about conflicts of interest and obtain informed client consent.[36] The Advisers Act recognizes, similar to common law, that conflicts of interest are always present, and therefore imposes obligations designed to allow clients to consent to those conflicts.[37] The disclosure of conflicts of interest allows the client to "make an informed decision as to whether to enter into or continue an advisory relationship with the adviser or whether to take some action to protect himself against the specific conflict of interest involved."[38] While a client cannot agree to waive an investment adviser's compliance with its obligations under Section 206(1) and (2),[39] an investment adviser can appropriately chisel the contours

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[34] *See id.* at 191–92. (Emphasis added.) In addition, the Court described an investment adviser's fiduciary duties as including "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading'" clients. *See id.* at 194.

[35] *Id.* at 196 (quoting *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520, 549 (1961)).

[36] *See, e.g.*, *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952 (7th Cir. 2004) (upholding SEC's finding that adviser violated Section 206(2) by failing to disclose that it allocated shares of IPOs to certain directors of its mutual fund clients); *Vernazza v. SEC*, 327 F.3d 851, 858–59 (9th Cir. 2003) (upholding the SEC's finding that failure to disclose a financial interest in recommending securities to clients violated Section 206(1) and (2)); *SEC v. Blavin*, 760 F.2d 706, 711–12 (6th Cir. 1985) (affirming district court's grant of summary judgment to the SEC where adviser failed to disclose it was trading in securities that it recommended to clients). *But see SEC v. Moran*, 922 F. Supp. 867, 898 (S.D.N.Y. 1996) (finding adviser violated Section 206(2) by inadvertently allocating stock to the adviser's account rather than to its clients' accounts, without addressing whether this was inconsistent with disclosures to clients).

[37] *See, e.g.*, Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 81 (2004) ("Most fiduciaries act for more than one principal."); Frankel, *Fiduciary Law*, *supra* note 9, 71 CALIF. L. REV. at 824 ("Because it is costly to find a fiduciary whose interests are identical with those of the entrustor, much of fiduciary law is designed to prevent the fiduciary from using delegated power to further interests other than those of the entrustor."); *Frankel & Schwing*, *supra* note 7, at § 14.01 ("[F]iduciaries are exposed to conflict of interest. After all, they are entitled to gain a livelihood, and their promises and performance of their service may drive them to seek higher compensation and lower service efforts. Some of the most serious conflicts of interest related to these two areas: higher compensation and lower service efforts.").

[38] Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release 1092, (Oct. 8, 1987), 52 Fed. Reg. 38400, 38404 (Oct. 16, 1987).

[39] *See* Opinion of the General Counsel, Relating to the Use of "Hedge Clauses" by Brokers, Dealers, Investment Advisers, and Others, Investment Advisers Act Release No. 58, 16 Fed. Reg. 3387 (Apr. 18, 1951).

of the relationship with a client by agreement with the client, including both to obtain consent to action that would otherwise constitute impermissible self-dealing and to define the extent of obligations owed under the duty of care. We recommend that the Commission reconsider its articulation of fiduciary duty and make clear that, consistent with common law and Commission precedent, the duty of loyalty does not require investment advisers to eliminate conflicts of interest, but rather requires advisers to provide appropriate disclosure of conflicts of interest so that clients can evaluate the conflicts and provide informed consent.

B. *References to "Best Interest" Cloud Proper Articulation of Suitability Obligation*

The Proposed Interpretation would recast the obligations that flow from an investment adviser's duty of care as requiring not only that an adviser provide suitable investment advice, but also that the advice be in the *best interest* of the client. The Proposed Interpretation attempts to support the incorporation of a best interest component to an investment adviser's suitability obligation by stating, "[w]e believe that this obligation [suitability], when combined with an adviser's fiduciary duty to act in the best interest of its client, requires an adviser to provide investment advice that is suitable for *and in the best interest of* its client,"[40] but the Commission offers no further support for this interpretation.

The Proposed Interpretation appears to be a new articulation of an investment adviser's suitability obligations that is not reflected in prior Commission or Staff precedent (including the 1994 Proposed Suitability Rule for advisers, which the Commission notes in the Proposed Interpretation reflects its interpretation of an adviser's existing suitability obligation under the Advisers Act.)[41] It is also inconsistent with common law, under which the obligation to act in a client's best interest arises under the duty of loyalty and, as discussed above, recognizes that a fiduciary may benefit from a transaction provided the client has given informed consent.[42] We believe that the inclusion of the best interest standard is misplaced in that it should not be part of the duty of care at all, and instead, consistent with common law and prior Commission and Staff precedent, should be limited to an articulation of the existing duty of loyalty. Layering in a best interest component to an adviser's suitability obligations amounts to rulemaking under the Advisers Act through interpretation. It also introduces unnecessary ambiguity as to when an adviser would be deemed to have provided advice that meets a best interest standard such that an adviser satisfies its duty of care.

As a further matter, the Commission does not define the term "best interest" in connection with an investment adviser's suitability obligations. The use of the "best interest" terminology raises the question of whether the reference to best interest in the Proposed Interpretation should be read as parallel to, or as incorporating, the guidance included in Regulation BI. In other words, we question whether an investment adviser (particularly, a dual registrant) would need to satisfy the Regulation BI obligations relating to disclosure, care and conflicts of interest in order to satisfy its suitability

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[40] Proposed Interpretation at 21206, FN 26 (emphasis added).

[41] *Id.* (citing to Suitability of Investment Advice Provided By Investment Advisers; Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406, 17 C.F.R. Part 275 (Mar. 22, 1994) [hereinafter, "Proposed Suitability Rule"]).

[42] *See supra* notes 16-17.

obligations under the Proposed Interpretation. Although the Commission "does not intend that Regulation Best Interest, including the associated obligations, have any impact on the Commission's or its staff's interpretation of the scope or nature of an investment adviser's fiduciary obligations,"[43] the Proposing Interpretation does not offer an alternative construction as to what best interest means for investment advisers.

C. *Proposed Interpretation Over-Generalizes Fiduciary Standard of Care in Ways that Do Not Sufficiently Distinguish Types of Investment Adviser Relationships*

Although the Commission correctly notes in the Proposed Interpretation that fiduciary duty is a principles-based standard that will "follow the contours of the relationship between the adviser and its client" and is "[shaped] through contract,"[44] the Proposed Interpretation does not sufficiently distinguish between the gradations of responsibility that an investment adviser has depending on the extent of the adviser's authority when providing advice to clients.

The common law provides that the fiduciary duties that an agent owes to a principal vary depending on the parties' agreement and the scope of their relationship.[45] The scalable nature of fiduciary protections can be seen in the common law through the different application under agency law and trust law. Under agency law, the scope of fiduciary duties depends on the nature of the power the agent has over the principal's business, which is generally non-discretionary and limited to a particular transaction.[46] The protections are somewhat lowered in an agency relationship where the principal retains ultimate decision-making authority.[47] In comparison, because a trustee generally has greater powers over trust assets, including ongoing investment discretion, trust law imposes stronger obligations on trustees.[48] Nonetheless, under agency and trust law, a fiduciary may appropriately negotiate with the client on an arm's-length basis and agree with the client on the scope and terms of the relationship, including the fiduciary's obligations in managing the account and the scope of advice it will provide.

Fiduciary obligations depend on the extent of an adviser's authority and the client's reliance on the adviser. For instance, a discretionary investment adviser will face higher obligations in providing advice than would be present in a non-discretionary relationship or in the case of an

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43 Regulation BI Proposal at 21585.

44 Proposed Interpretation at 21205.

45 *See Restatement (Third) of Agency* § 8.01 cmt. c ("Fiduciary obligation, although a general concept, is not monolithic in its operation. In particular, an agent's fiduciary duties to the principal vary depending on the parties' agreement and the scope of the parties' relationship.").

46 *See* Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 714 (2010) (discussing how a broker's fiduciary obligations relate to the scope of agency); *see also Frankel & Schwing, supra* note *7* at § 13.01(A)(3).

47 *See, e.g.*, Frankel & Schwing, *id.* ("[A]gency rules are more lax than trust rules. Agents are only considered fiduciaries with respect to matters within the scope of the agency.").

48 *See, e.g.*, Tamar Frankel, *Fiduciary Law in the Twenty-First Century*, 91 B. U. L. REV. 1289, 1297 (2011) (discussing how the strictness of rules and remedies turn on the risk of the fiduciary's abuse and the ability and cost of controlling and limiting the fiduciary's entrusted property and power).

investment adviser providing advice in the form of model portfolios.[49] However, even though it recognizes the general principle that fiduciary obligations will vary, the Proposed Interpretation paints the variances in fiduciary duty with a broad brush, and therefore fails to distinguish how fiduciary obligations may be graduated depending on different advisory services and business models. Specifically, it appears that the Proposed Interpretation focuses on an investment adviser's obligations in providing investment advisory services directly to a client, and does not seem to contemplate how fiduciary responsibilities apply in arrangements involving more than one investment adviser or fiduciary (e.g., managed account programs through which investment advisory services are provided by or in conjunction with the services of multiple investment advisers and fiduciaries, such as program sponsors, sub-advisers and overlay managers, among others). Such arrangements are a core component of the current market for retail investment advisory services, and consequently the Commission should meaningfully address and confirm in any interpretation the fact that fiduciary responsibilities may be defined and allocated among multiple investment advisers.

Importantly, any interpretation that the Commission articulates should not assume that the obligations of all investment advisers and other fiduciaries participating in managed account programs are the same or co-extensive with one another. As the Commission is no doubt aware, an investment adviser or other fiduciary's responsibility within a managed account program will vary greatly depending on the particular services they perform for clients or provide to the program sponsor. For instance, the provision of investment strategies for implementation and monitoring by a program sponsor will present significantly different day-to-day responsibilities from those of sub-advisers with full discretionary investment and trading authority. Consequently, the Commission's interpretation should recognize that such obligations – including suitability obligations in managed account programs – are not the same across all investment advisers or other fiduciaries involved in the particular advisory offering, and may be delegated and allocated among these participants pursuant to agreements between or among such parties, client agreements, disclosures and applicable law.

Correspondingly, any interpretation should recognize that an investment adviser or other fiduciary may rely on another investment adviser or fiduciary in connection with the performance of delegated or allocated obligations. These obligations include suitability obligations in managed account programs, including the suitability of a given program to a client, the suitability of a given strategy within that program for a client, the suitability of an investment adviser for implementation of that given strategy, and the suitability of an investment adviser's investment recommendations or decisions for that strategy. In many managed account programs, a portfolio manager responsible for management of a given investment strategy will not have (or wish to have) access to a client's "investment profile" (or the non-public personal information contained in it), and its responsibilities under the program would not be impacted even were it to have access to such information. Providing portfolio managers with non-public personal information about clients not only is unnecessary given

[49] The Commission and its Staff have consistently recognized that the fiduciary obligations of non-discretionary investment advisers, or advisers that provide only impersonal advice, are distinct from those of discretionary advisers. For instance, investment advisers providing personalized, non-discretionary advice are exempt from the presumption of proxy voting authority and responsibility and the corresponding requirements of Advisers Act Rule 206(4)-6, and investment advisers are not required to deliver their brochure to clients who receive only impersonal investment advice and that are charged less than $500 per year under Advisers Act Rule 204-3(c).

the portfolio manager's role, but exacerbates data security issues. In addition, under any interpretation, a portfolio manager in a managed account program should be able to satisfy its suitability obligations by selecting securities that are consistent with the portfolio manager's strategy. Portfolio managers in managed account programs should not be obligated to make an inquiry into the client's investment profile at account inception or over time if the responsibility for determining the suitability of the client for the program and the strategy is held by the program sponsor or another investment adviser.

D. *Proposed Interpretation Over-Generalizes in Ways that Do Not Distinguish Retail from Institutional Advice*

In contrast to Regulation BI, which draws distinctions in the conduct standards applicable to broker-dealers when providing advice to non-institutional retail customers, the fiduciary principles discussed by the Commission in the Proposed Interpretation would be of general applicability across all types of investment advisers. However, the Commission's interpretive positions appear largely geared to the provision of investment advisory services to retail clients in ways that do not apply to advice to non-retail clients. For example, the Commission states that an investment adviser is required to make a "reasonable inquiry" into a client's investment profile, including the client's "financial situation, level of financial sophistication, investment experience, and investment objectives," and "provide personalized advice that is suitable for and in the best interest of the client based on the client's investment profile."[50]

The concept of an "investment profile" as used in the Proposed Interpretation appears geared to individual clients. Yet, it is unclear whether, and if so, how, the Commission intends that the concept of an "investment profile" applies to an entity or institutional client (e.g., a private fund, investment company, or other institutional account), which often will itself (or through a consultant or other investment adviser) select a strategy or mandate and may or may not specify investment guidelines (instead of a "profile"). In view of this uncertainty, the Commission should draw distinctions in its interpretation that recognizes the differences between the manner in which investment advisors service retail clients and non-retail clients, as well as the differing responsibilities implicated by such relationships.

The Commission should similarly recognize that the concept of an "investment profile" must be broadly interpreted and may include a range of different components depending on the nature of the advice provided. For example, while financial situation, level of financial sophistication, investment experience and investment objectives may be more or less relevant in the context of a traditional managed account program, they will have little application to a digital advisory program. In that context, financial situation would be limited to whether the client has sufficient assets to invest, and it is often assumed – particularly in programs that are geared to small accounts (e.g., programs with no account minimums) or are designed to help build financial wellness – that a client has no financial sophistication or investment experience. Even the concept of an "investment objective" is outdated in the context of goals-based investing where the account is not managed against an investment objective, but rather against the goal of accumulating wealth to meet a particular financial goal (e.g., saving for retirement or buying a home).

[50] Proposed Interpretation at 21206.

Finally, we note that the concept of an investment profile does not currently exist under the Advisers Act. Although the Commission's Proposed Suitability Rule (which does not use the term) and Rule 3a-4 under the Investment Company Act of 1940 (which is not a suitability rule) reference certain factors that advisers should consider in providing advice, the Commission has never mandated that investment advisers obtain particular information about their clients. We respectfully submit that any context provided by the Commission around the definition of an "investment profile" and its required use would have to be issued through the Commission's rulemaking authority, and not through an interpretation. In any event, any requirement to update a client's investment profile should address the relationship of such principles to the requirements of Rule 3a-4 for discretionary investment management programs. Specifically, the Commission should confirm that the quarterly notification and annual contact requirements of Rule 3a-4[51] satisfy any ongoing obligation to make a reasonable inquiry into a client's investment profile.

E. *Proposed Interpretation's Statements on the Need for Advisers to Conduct Reasonable Investigations Are Unclear and Do Not Reflect the Nuances Required by Varying Circumstances*

The Commission states that the duty of care requires an adviser to "conduct a reasonable investigation into [an] investment sufficient to not base its advice on materially inaccurate or incomplete information."[52] We do not think that the Commission has adequately articulated what level of investigation would be sufficient such that an adviser is "not [basing its] advice on materially inaccurate or incomplete information." The ambiguity of this standard creates strong potential for second-guessing with the benefit of hindsight (e.g., the performance of an investment) whether the "right" types of information were gathered. We therefore urge the Commission to recognize and acknowledge in any interpretation that what is "sufficient" for these purposes may vary depending on the circumstances, including from strategy to strategy. For example, the investigation that might be needed to confirm that a specific security is appropriate for a growth strategy may differ from the investigation needed to confirm that that security is appropriate for a value strategy.

Moreover, the Commission should recognize and acknowledge that an investment adviser should have discretion in the discharge of its professional judgment to determine whether it has sufficiently complete information on which to base an investment decision, taking into account the adviser's strategy and investment philosophy, the client's intended investment horizon and amount of investment, and other relevant factors. We urge the Commission to acknowledge that an investment adviser should be able to assume, without inquiry, that certain information is accurate and complete (e.g., filings with the Commission made by public companies). Investment advisers should further be able to rely on the expertise of investment sub-advisers, the providers of model portfolios and others whom the investment adviser reasonably believes offers sound advice and perspectives without having to do a *de novo* review each time a new investment is recommended, except to the extent the investment adviser actually knows of "red flags" that call such information into question.

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[51] Rule 3a-4(a)(2)(ii) and (iii) of the Investment Company Act of 1940.

[52] Proposed Interpretation at 21207, text accompanying FN 31.

F. *Proposed Interpretation Targets Conflicts Disclosure for Being Non-Specific, But Offers Little Specifics in Terms of Guidance*

The Commission states that "[a]n adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure to its clients of all material conflicts of interest that could affect the advisory relationship."[53] According to the Commission, the disclosure must be clear and detailed enough and contain sufficiently specific facts to allow the client to make a reasonably informed decision whether to consent to the conflicts.[54] Although the Proposed Interpretation focuses on the clarity and specificity of disclosure, it fails to articulate any meaningful guidance to evaluate whether disclosure meets that criteria. Moreover, the guidance the Proposed Interpretation does provide is misplaced and potentially subjects investment advisers to the risk that the Commission or the Staff will view that disclosure as inadequate with the benefit of hindsight.

The Commission states that an adviser would violate its fiduciary duty if it infers or accepts consent to a conflict where "(i) the facts and circumstances indicate that the client did not understand the nature and import of the conflict, or (ii) the material facts concerning the conflict cannot be fully and fairly disclosed."[55] We believe both prongs of this standard are problematic.

First, the Commission's approach equates complicated facts surrounding a conflict or complex products with an assumption that the conflict itself is equally complicated. The Commission states that the complexity of facts surrounding a conflict can mean that disclosure will not suffice to address the conflict, in which case the Commission expects an adviser to eliminate the conflict or "adequately mitigate the conflict so that it can be more readily disclosed."[56] The Commission cites as examples highly complex products or other investments with "extensive conflicts" where it would be difficult to provide sufficiently specific and understandable disclosure to clients. According to the Commission, this could involve conflicts for which disclosure cannot "adequately [convey] the material facts or the nature, magnitude and potential effect of the conflict" or disclosure that is not specific enough to allow clients to understand whether and how the conflict will affect the advice they receive.[57] While it is clear that more extensive disclosure to obtain informed consent would be warranted in cases of more extensive (i.e. complicated) conflicts, the Commission does not articulate a cognizable standard for why (and when) a conflict is so complicated that disclosure alone would be insufficient.

Second, the Proposed Interpretation requires advisers to make subjective and hypothetical determinations of what particular classes of clients, or specific individuals, may or may not sufficiently understand an adviser's disclosure such that they are making an "informed decision." Beyond citing

[53] *Id.* at 21208.

[54] *Id.* at text accompanying FN 40.

[55] *Id.* at 21209, text accompanying FN 48.

[56] *Id.*

[57] *Id.*

a 2013 comment letter,[58] the Proposed Interpretation does not define or otherwise provide criteria that bear on whether a conflict can be meaningfully disclosed to investors, or which particular facts and circumstances would indicate that a client does not understand the nature and import of a conflict. The appropriate standard for obtaining informed consent should be whether an adviser has provided disclosure that is clear, accurate, and sufficiently detailed to inform a reasonable client about the given conflict, and not a standard that requires an adviser to subjectively weigh the nature and extent of different conflicts and a client's hypothetical or actual comprehension of them. Under the notions of implied consent that are incorporated into the framework of disclosure under the Advisers Act, including Form ADV Part 2, a client should be deemed to have agreed with the disclosure by continuing to accept the investment adviser's services unless the client objects, or raises a question to the adviser regarding the circumstances detailed in the disclosure. An investment adviser should not be required to undertake a client-by-client consultation to evaluate whether individual clients understand the conflicts that are described in its disclosures.

Further, the Proposed Interpretation continues the Commission's criticism of equivocal disclosures, stating that "an adviser disclosing that it 'may' have a conflict is not adequate disclosure when that conflict actually exists."[59] Notwithstanding the Commission's critique of qualified disclosures in this context, use of the word "may" or similar qualifiers in disclosure language is often both appropriate and necessary given the varying or conditional nature of the investment adviser's practices and compensation arrangements. Several federal court decisions support appropriate use of "may"-based disclosures. For example, the Second Circuit Court of Appeals held in *Mendell v. Greenberg* that, even where the disclosure at issue used the word "may" instead of "will," "a reasonable investor would still have been on notice that additional [financial] incentives were most likely and should have been anticipated."[60] In *Hoffman v. UBS-AG*, the U.S. District Court for the Southern District of New York held that disclosing the "possibility" of a financial arrangement in a prospectus was sufficient because investors received adequate notice to make further inquiries.[61] Moreover, arguments that a firm's statements were "disclosure failures" when they stated that the firm "may" receive certain compensation or engage in certain practices as compared to "does" might be said to be "semantic quibble" and certainly not material omissions in and of themselves.[62] Indeed, the use of "may" can

[58] *See id.* at 21206, FN 21 (citing a March 2013 comment letter of the Financial Planning Coalition stating that "[D]isclosure alone is not sufficient to discharge an investment adviser's fiduciary duty; rather, the key issue is whether the transaction is in the best interest of the client.").

[59] *Id.* at 21209.

[60] 927 F.2d 667, 679 (2d Cir. 1990).

[61] 591 F. Supp. 2d 522, 534 (S.D.N.Y. 2008) ("Defendants' prospectuses were not misleading or incomplete to the extent that they disclosed the possibility of entering into a shelf-space arrangement… The language used in Defendants' prospectuses gave investors adequate notice of the possibility of shelf-space agreements, arrangements about which investors could have inquired if they felt that such agreements would compromise the service that they were receiving.").

[62] See *Benzon v. Morgan Stanley Distributors, Inc.*, 420 F.3d 598, 612 (6th Cir. 2005); *Lubbers v. Flagstar Bancorp Inc.,* 162 F. Supp.3d 571, 581 (E.D. Mich. 2016); *In re AIG Advisor Group Sec. Litig.*, No. 06 CV 1625 (JG), 2007 WL 1213395 at *8 & n. 15 (E.D.N.Y. April 25, 2007); *In re Morgan Stanley and Van Kampen Mutual Fund Sec. Litig.*, No. 03 Civ. 8208 (RO), 2006 WL 1008138 at *7-*8 (S.D.N.Y. April 18, 2006); *In re RAC Mortgage Investment Corp. Sec. Litig.*, 765 F. Supp. 860, 864 (D. Md. 1991). We note that the Staff's reliance at times (although not in connection with the Advisers Act Interpretation) on *SEC v. Merchant Capital, LLC* arguably is misplaced. 483

be entirely appropriate where the conflict or its materiality depend on facts and circumstances and, as such, are contingent. This principle is aligned with Supreme Court case law holding that, where an event (or in this context, a conflict or its materiality) is contingent, materiality should depend on a "balancing of both the indicated probability that the event [or conflict or its materiality] will occur and the anticipated magnitude of the event [or conflict] in light of the totality" of the circumstances.[63]

Ultimately, whether disclosure suffices and whether a given client's consent is "informed" are judgments that cannot be addressed categorically or through overgeneralizations. We encourage the Commission to collaborate with industry to develop prudential guidelines for retail disclosure of conflicts of interest that are appropriate to the circumstances. In this regard, we note that accumulated Commission and Staff guidance on disclosure obligations tends to be inconsistent. Even Form ADV Part 2 disclosure requirements on conflicts vary in terms of the level of information and specificity of disclosure that is required.[64] In addition, Form ADV Part 2 does not specifically require that an adviser disclose the significance or magnitude of conflicts.

G. *Proposed Interpretation Over-Plays Considerations of Cost and Under-Plays Significance of Disclosure*

The Proposed Interpretation states that the cost (including fees and compensation) associated with advice "would generally be one of many important factors" for an investment adviser to consider when forming a reasonable belief that personalized advice is suitable for and in the best interest of the client, based on that client's investment profile.[65] While the Commission acknowledges that "the fiduciary duty does not necessarily require an adviser to recommend the *lowest cost investment product or strategy*," the Commission goes on to state its belief that "an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is otherwise identical, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance."[66]

F.3d 747, 769 (11th Cir. 2007). The defendant there affirmatively misrepresented the company's historical performance in statements to investors, "paint[ing] a rosy picture," when in fact the company had been performing poorly. The company then sought to avoid liability for its fraud by including general cautionary language that "there was no assurance Merchant '[would] *continue to be successful*,'" in its performance. *Id.* The Eleventh Circuit Court of Appeals held that the cautionary language used was itself affirmatively false and misleading, and, for that reason, it did not "cure" the defendant's fraud or negate a finding of materiality.

[63] *See Basic, Inc. v. Levinson*, 485 U.S. at 238.

[64] For instance, Item 14 ("Client Referrals and Other Compensation") of Form ADV Part 2A requires investment advisers to generally disclose conflicts and compensation associated with client referral arrangements, whereas Item 12 ("Brokerage Arrangements") requires that an adviser make specific disclosure to clients regarding the incentive for an adviser to recommend particular broker-dealers based on research or soft dollars that they may receive.

[65] Proposed Interpretation at 21207.

[66] *Id.* (emphasis added).

Although we draw comfort from the "otherwise identical" language used by the Commission,[67] in practice, advice on program, strategy and investment options seldom involves alternatives that are in fact "identical." In this regard, the Proposed Interpretation provides a vague standard for when two investment alternatives are "identical," noting that "any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance" would have to be identical. However, this fails to take into account the reality that no two advisory programs, investment strategies or investment options will be precisely identical in all circumstances, and therefore the Proposed Interpretation's emphasis on cost may incline an adviser to in many cases skew towards recommending or selecting a less expensive option in order to fulfill its obligations under the Proposed Interpretation, even where a more expensive alternative would be more consistent with a client's investment profile and objectives (and therefore fulfillment of the adviser's own suitability obligations).

We recommend that the Commission continue its long-standing approach in this context favoring disclosure, including in the context of more expensive mutual fund share classes,[68] as well as for wrap fee programs, where advisers must disclose that the program may cost the client more or less than purchasing such services separately, and describe the factors that bear on the relative cost of the program (*e.g.,* the cost of the services if provided separately and the trading activity in the client's account).[69]

H. *Obligation to Allocate Investment Opportunities on a Fair Basis is not Absolute*

In generalizing an investment adviser's obligations as a fiduciary, the Proposed Interpretation does not appear to take into account distinctions in the scope and nature of an adviser's fiduciary relationship among its different advisory clients. The Proposed Interpretation states that in allocating investment opportunities among clients, an adviser must treat all clients fairly – namely "that an adviser's allocation policies must be fair and, if they present a conflict, the adviser must fully and fairly

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[67] *See id* ("We believe that an adviser could not reasonably believe that a recommended security is in the best interest of a client if it is higher cost than a security that is *otherwise identical*, including any special or unusual features, liquidity, risks and potential benefits, volatility and likely performance.") (Emphasis added)

[68] *See id* at text accompanying FN 30 ("For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's return, the adviser may violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict."); *see also Announcement: Share Class Selection Disclosure Initiative*, Division of Enforcement, U.S. Securities and Exchange Commission (Apr. 18, 2018) ("A 'Self-Reporting Adviser' is an adviser that received 12b-1 fees in connection with recommending, purchasing, or holding 12b-1 fee paying share classes for its advisory clients when a lower-cost share class of the same fund was available to those clients, and failed to disclose explicitly in its Form ADV the conflicts of interest associated with the receipt of such fees.")

[69] *See* Item 4.B. of Form ADV Part 2A Appendix 1 ("Explain that the program may cost the client more or less than purchasing such services separately and describe the factors that bear upon the relative cost of the program, such as the cost of the services if provided separately and the trading activity in the client's account.

disclose the conflict such that a client can provide informed consent."[70] However, this proposition does not recognize that a fiduciary's obligation to allocate investment opportunities depends on the nature of the relationship between the adviser and its client and related disclosures and, in any event, only arises with regard to similarly situated clients. An investment adviser should not necessarily be said to have the same obligations for allocating investment opportunities to: (i) clients to which the investment adviser provides non-discretionary advice (including, for example, model portfolios) as it does clients to which the investment adviser provides discretionary advice; or (ii) clients for which the investment adviser has brokerage or trading discretion as it does clients for which the investment adviser does not. Moreover, an investment adviser should not be subject to a duty to allocate investment opportunities on a fair or equitable basis where it clearly discloses that it will not do so or where, given the circumstances of the client relationship, the investment adviser's practice in this regard does not raise a material conflict of interest.

III. *Form CRS*

We understand the Commission's concern that meaningful confusion persists among investors as to the contours of their advice provider's standard of conduct in different types of advisory and brokerage relationships. However, we are concerned that layering on an additional disclosure document would frustrate this objective by inundating clients or customers with an additional disclosure document that in many respects is duplicative of content that advisers and broker-dealers are already required to disclose, including in Part 2 of Form ADV. The addition of Form CRS is of particular concern in the context of managed account programs, where clients often receive multiple Form ADV Part 2 brochures (e.g., for the program sponsor, discretionary portfolio managers, and overlay managers). Additionally, we are concerned that it may not be possible for advisers with a multitude of product offerings to meaningfully disclose information about all of their services and fees in one four-page summary, without it being inherently misleading. Consequently, we do not think that the addition of Form CRS would meaningfully address the issues identified by the Commission in the Proposals, and urge the Commission to reposition Form CRS as an investor education document that the Commission could publish to provide an additional resource for investors.

In the alternative, rather than add to the volume of disclosure provided to investors by adopting Form CRS, there are steps the Commission could take to streamline existing disclosure requirements and enhance the coverage of an investment adviser's disclosures. For instance, we recommend that the Commission amend Form ADV, Part 2A to combine it with Appendix I (the wrap fee brochure). As currently drafted, many of the questions in each of Part 2A and Appendix I can be relevant to investment advisory programs that would only be required to complete the other part. Moreover, firms often confront situations where it is not entirely clear whether a given advisory program qualifies as a wrap fee program such that completion of an Appendix I (and not Part 2A) would be warranted. Combining the content of Part 2A and Appendix I into a brochure of general applicability would create a more cohesive disclosure document, which in turn would facilitate ease of preparation by advisers and ease of comprehension by investors.

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[70] Proposed Interpretation at 21208.

Separately, we request that the Commission provide additional flexibility around the delivery requirements for Form CRS and Form ADV more generally to permit valid electronic delivery through access (e.g., by posting on a publicly accessible website). In this regard, we would also ask the Commission to use the Proposals as an opportunity to address the interplay of the client delivery requirements of the Advisers Act with Congress's directive to federal agencies under the Electronic Signatures in Global and National Commerce Act ("E-SIGN").[71]

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We hope that our comments are helpful to the Commission and Staff as they further refine their approach to standards of conduct for broker-dealers and advisers. We would be glad to answer any questions or provide further assistance. Please feel free to contact me at ([redacted] or contact Hilary Fiorella at [redacted].

Sincerely,

Craig Pfeiffer
President and CEO
Money Management Institute

[71] *See* Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 7001 *et seq.*, Public Law 106-229 (Jun. 30, 2000) at § 7004(b).