REMINGER

SEC Guidance on RIA Standard of Care and Broker-Dealer Exemption

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PRACTICE AREAS

Financial Services
Professional Liability

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While the financial service industry was hemming and hawing over the publication of Regulation Best Interest (Reg BI), and debating how broker-dealers are expected to reconcile commission-based sales with federal mandates on disinterested recommendations to retail investors, the Securities and Exchange Commission slipped out two different, and quite significant, interpretations on: (1) the investment advisers standard of care, and (2) what it means to render investment advice "solely incidental" to activity as a broker-dealer.

In this regard, the Investment Advisers Act of 1940 ("Act") establishes a federal fiduciary duty for investment advisers based on equitable common law principles of care and loyalty.[1] The combination of care and loyalty has been characterized as requiring the investment adviser to act in the "best interest" of its clients at all time.[2] Therefore, one can reasonably assume these interpretative materials will be used in the future to craft guidance under Reg BI, and, it would seem, the writing is on the wall.

Toward those ends, the SEC drills down on what it means to be a fiduciary, and how advisers can satisfy the duty of care and loyalty under this regime:

- Duty to Provide Advice That Is in the Best Interest of the Client. "In order to render such advice, an adviser must have a reasonable understanding of the client's objectives."[3] Sound familiar? FINRA has long applied a reasonable basis standard on recommendations to retail customers.[4] Much like FINRA, the SEC suggests the best way to understand these objectives is to ask the client about their: (a) Financial Situation; (b) Level of Financial Sophistication; (c) Investment Experience; and (d) Financial Goals. Then, the RIA need only record the answers on their books and records.
- Duty to Seek Best Execution. When the adviser is allocated responsibility to select a broker-dealer, the adviser must obtain the execution of transactions such that the total cost or proceeds are the most favorable under the circumstances.
- Duty to Provide Advice and Monitoring Over the Course of the Relationship. Like other duties, this can be defined by the advisory agreement, but when an adviser is compensated with periodic asset-based fees, they are expected

to monitor the investments as a natural consequence of the relationship. The opposite is true for limited engagements, like the preparation of a one-time financial plan.

- Duty to Make Full and Fair Disclosure of All Material Facts. Material facts relating to the advisory relationship include the capacity in which the firm is acting with respect to the investment advice. Thus, it is paramount that advisers clarify when they are acting in their broker capacity and when they are acting in an advisory capacity. As before, full and fair disclosure will depend upon the nature of the client and the scope of the advisory relationship, which can be defined by the contract but cannot be eliminated.
- Duty to Render Disinterested Investment Advice:
  - Appropriate Level of Specificity: For disclosures to be full and fair, they should be sufficiently specific so that a client is able to understand the material fact or conflict at issue and make informed decisions. Much like the recent Share Class Selection Disclosure Initiative, disclosures that advisers "may" have a conflict will not be adequate.
  - Allocation of Investment Opportunities Among Eligible Clients. Allocating investments among eligible clients creates a conflict that must be disclosed, mitigated, or eliminated. Thus, the adviser must disclose its allocation policy and how it will allocate those opportunities. While the adviser need not have a *pro rata* allocation system, it must disclose the basis and process for those decisions.

As before, the full and fair disclosure, as well as the adequacy of conflict management, will turn on statements made in the client brochure under Part 2A of Form ADV.

The second Release narrows the scope of the "solely incidental" prong of the broker-dealer exclusion under the Act.[5] While still viewed on a "fact and circumstances basis," the advice must be "provided in connection with and [be] reasonably related to the broker-dealer's primary business of effecting securities transactions."[6] While certain temporary or limited discretion, such as "price and time" on identified securities, may still fall within the exemption, a broker-dealer will not be exempt from the Act when exercising investment discretion or monitoring performance.

Indeed, these interpretations are a sign of things to come and the experienced attorneys in our Financial Services Liability Practice Group would be happy to listen to your concerns or answer any questions with regard to these recent developments.

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[1] *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 194 (1963) (discussing the history of the Advisers Act, and how equitable principles influenced the common law of fraud and changed the suits brought against a fiduciary, "which Congress recognized the investment adviser to be").

[2] Investment Advisers Act Release 3060, footnote 15 (adopting amendments to Form ADV and stating that "under the Advisers Act, an adviser is a fiduciary whose duty is to serve the best interests of its clients, which includes an obligation not to subrogate clients' interests to its own).

[3] SEC Release No. IA-5248

[4] FINRA Rule 2111

[5] Section 202(a)(11) of the Act defines “investment adviser” as persons who, for compensation, engage in the business of advising others about securities, but excludes broker-dealers “whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation” for those services.

[6] SEC Release No. IA-5249