

## **CCS Summary**

### *SEC Proposal Regarding Standard of Conduct for Investment Advisers*

Stacey Gillespie, Compliance Director, Cipperman Compliance Services

In an effort to reaffirm and clarify its views regarding the fiduciary obligations registered investment advisers owe to their clients, the Securities and Exchange Commission released a fiduciary rule interpretation (hereinafter, the “RIA Conduct Standard”) this month that more clearly defines the Commission’s somewhat imprecise historical views. The interpretation does not attempt to limit the types of investments products an adviser should recommend when acting as a fiduciary, or even suggest that advisers must consider the lowest cost products for clients, but rather it attempts to define additional items an adviser must consider in its role as a fiduciary.

“Fiduciary Duty” is a term generally defined by common law. In *SEC v. Capital Gains Research Bureau, Inc.*, the court imposed a federal fiduciary duty on advisers by operation of law. As applied to investment advisers, the duty holds advisers to the highest standard of conduct, requiring that they act in the best interest of its client.

#### **Duty of Care**

The RIA Conduct Standard provides additional SEC viewpoints on the longstanding concept of “Duty of Care”. Fundamentally, advisers, as fiduciaries, are required to (i) act and provide advice that is in the best interest of the client, (ii) seek best execution in situations where the adviser selects broker-dealers to execute trades, and (iii) provide advice and monitoring over the course of the relationship. The Commission states that the duty of care includes a duty to make a reasonable inquiry into a client’s financial situation, level of financial sophistication, investment experience and investment decisions (collectively referred to as the “client profile”) and to provide personalized advice that is suitable and in the best interest of that client based on their client profile.

Additionally, an adviser’s obligation to provide a duty of care does not end once the adviser client profile has been obtained. In fact, the Commission states that the adviser has an ongoing obligation to inquire as to any changes to a client’s investment profile and update its investment advice accordingly. Advisers should make an ongoing effort to stay informed of events such as changes to tax laws, client employment status and marital or familial status in order to be able to continuously provide sound, suitable advice. Furthermore, advisers should not solely rely on a client to provide updated information, but should proactively and continuously make efforts to obtain from clients any changes that may materially alter their client profile.

#### **Best Execution**

The RIA Conduct Standard provides additional clarity on Best Execution. Though there has been some previous guidance in this area, there is no specific rule defining best execution, leaving industry participants with inconsistent standards when evaluating best execution. Historically, the SEC has

asserted that in assessing whether the standard of best execution is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research services provided. In the RIA Conduct Standard, the Commission codifies that an adviser must seek best execution such that a client's total cost or proceeds in each transaction are the most favorable under the circumstances. An adviser should focus on maximizing value for clients when trading under the particular circumstances occurring at the time of the trades. Additionally, the RIA Conduct Standard states that advisers have an ongoing duty to periodically and systematically evaluate execution quality.

### **Duty to Act and to Provide Advice and Monitoring over the Course of the Relationship**

Next, the interpretation addresses an adviser's obligation to provide advice and monitoring over the life of the relationship with a client. The Commission reaffirms its expectation that an adviser should provide advice and services to a client at a frequency that both conforms to the terms of the advisory contract, and that is in the best interest of a client. This is a particularly important clarification for advisers that charge on ongoing fee. The SEC expects advisers to earn their fees, and not simply sit back and collect them, having provided little or no service to clients.

Interestingly, the RIA Conduct Standard points out that monitoring client accounts not only includes a review of the investment advice an adviser offers a client, but also the client's account program type. In the RIA Conduct Standard release, the SEC specifically uses the example of "wrap accounts", a type of account that has undergone recent regulatory scrutiny due to the layers of fees and expenses and potentially limited engagement by advisers. If anything can be deduced from this example, it is that scrutiny of wrap accounts is not going away any time soon.

### **Duty of Loyalty**

One of the most basic tenets of fiduciary duty is the obligation of an adviser to disclose and mitigate all conflicts of interest. The SEC has long stated that the duty of loyalty means the adviser cannot place its own interests above those of its clients. They further clarify in the RIA Conduct Standard release that, while exceptions can be made on a facts and circumstances basis, an adviser's trading practices must be designed to treat all clients fairly. The interpretation codifies that the disclosure of conflict alone may not be sufficient for an adviser to comply with its duty of loyalty. The disclosure of conflicts must be presented in such a way that a client can be reasonably informed to either consent or reject such conflicts. Importantly, the interpretation states that if all material facts regarding conflicts are not presented in a way that a client can make an informed decision, an adviser may be in violation of its fiduciary duty if it accepts either explicit or inferred client consent. Simply stated, an adviser must be certain that a client is presented with, and understands, all material facts regarding the adviser's conflicts of interest, or the adviser may be in breach of its fiduciary duties.

The RIA Conduct Standard, along with the proposed broker-dealer best interest standards, is part of a long-awaited package of industry reforms that is sure to bring many changes, whether needed or not, to the financial services industry. While the RIA Conduct Standard does not introduce any surprising new concepts or guidelines, we believe that it provides some much-needed clarity in the space and should be viewed by investment advisers as a roadmap in meeting their fiduciary obligations.