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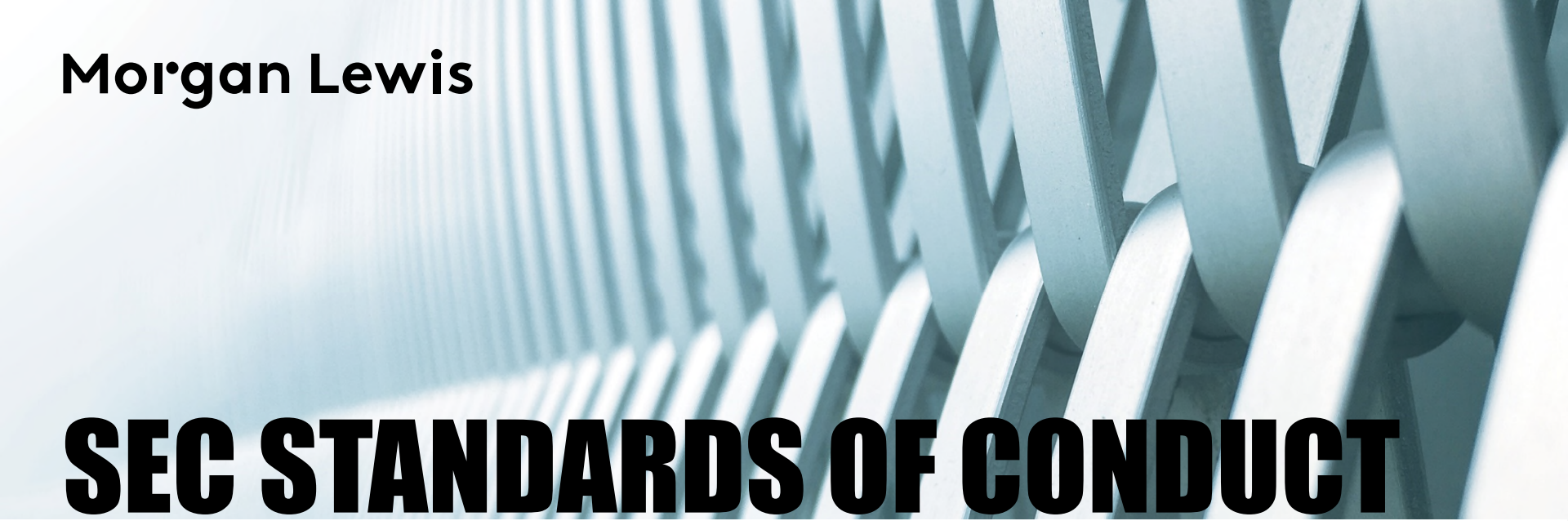

SEC STANDARDS OF CONDUCT

NAVIGATING THE INVESTMENT ADVISER INTERPRETATION

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Overview

- Standard of Conduct for Advisers
- Duty of Loyalty
- SEC Examination and Enforcement Considerations
- Duty of Care
- Next Steps

Standard of Conduct

- Standard of Conduct for Investment Advisers
  - The adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own
  - The adviser cannot place its own interests ahead of the interests of its clients
- Best Interest Obligation
  - "Overarching principle" that encompasses both the duty of care and the duty of loyalty
- Interpretation that is designed to "reaffirm – and in some cases clarify – certain aspects of the fiduciary duty that investment adviser owes to its clients under section 206 of the Advisers Act"
- Continues to be a flexible, principles-based standard
- Effective immediately with publication in Federal Register

Standard of Conduct

- Interpretation is not limited to retail clients
  - Applies to *all* clients
    - Clarification of application to institutional investors
  - Applies to wide range of advisory services
- Fiduciary duty applies to "entire relationship" between adviser and its clients, but the scope of the advisory relationship – and therefore the scope of the fiduciary duty – can be defined by agreement
- Fiduciary duty cannot be waived, and contract provisions that waive fiduciary responsibilities are inconsistent with the Advisers Act
  - SEC withdrew *Heitman* no-action letter

Duty of Loyalty

- An adviser may not *place its own interest ahead* of its client's interests
  - Reformulation of "the duty of loyalty requires an investment adviser to *put its client's interests first*"
- Disclosure
  - Requires an adviser to make full and fair disclosure to its clients of *all material facts* relating to the advisory relationship, including
    - Capacity in which firm is acting when providing advice, and any changes to capacity
    - Any limitation on menu of products offered
  - Disclosure and consent do not satisfy the duty to act in the client's best interest

Duty of Loyalty

- Conflicts of Interest
  - Adviser must eliminate or at least expose through full and fair disclosure *all conflicts of interest* which might incline an adviser – consciously or unconsciously – to render advice that is not disinterested such that a client can provide *informed consent* to the conflict
  - No materiality standard for conflicts of interest
  - Departure from General Instruction 3 to Form ADV, Part 2 – "make full disclosure of *all material conflicts of interest* between you and your clients that could affect the advisory relationship"
  - Language from the proposing interpretation, implying that disclosure is *per se* insufficient to address conflicts in certain circumstances, was softened to focus instead on how to obtain informed consent

Duty of Loyalty

- Informed Consent
  - No affirmative obligation to eliminate conflicts – focus is on whether adviser provides full and fair disclosure that is sufficiently specific to obtain "informed consent"
    - Disclosure should adequately convey the material facts or nature, magnitude, and potential effect of conflict on advice provided
    - For retail clients, balance between disclosure for complex or extensive conflicts that is sufficiently specific, but also understandable
    - If adviser cannot adequately disclose conflict, adviser should eliminate or mitigate (modify practices to reduce) the conflict
  - No "may"-based disclosure
  - Adequacy of disclosure considers nature of the client (institutional vs. retail)
  - Allocation of investment opportunities

Duty of Loyalty

- Informed Consent
  - Does not require an affirmative determination that a particular client actually understood the disclosure and provided informed consent
  - Rather, should be designed to put a client in a position to be able to understand and provide informed consent to the conflict of interest
  - Unless adviser is aware (or reasonably should have been aware) that client did not understand the nature and import of the conflict
- Consent may be in writing or implicit consent by entering into or continuing the advisory relationship

SEC Examination and Enforcement Considerations

- Impact of interpretation on OCIE examinations
  - Focus on documentation, training, policies/procedures
- Enforcement Considerations
  - SEC retains the authority to bring actions for a breach of fiduciary duty under Section 206
  - Disclosure-based defenses likely even more difficult once a matter reaches Enforcement

Duty of Care

- Advisers owe their clients a duty of care, which includes duty to
  - Provide advice that is in the best interest of, and is suitable for, the client based on a reasonable understanding of the client's objectives
    - Retail clients – investment profile
    - Institutional clients – investment mandate
  - Seek best execution of client's transactions where the adviser had the responsibility to select broker-dealers to execute trades
  - Provide advice and monitoring over the course of the relationship
- Non-exclusive list

Duty of Care

- Duty to provide advice that is suitable and in the best interest of clients extends to all investment advice, including advice about investment strategy, engaging a sub-adviser, and *account type*
  - Commission-based brokerage account or fee-based advisory account
  - Rollovers from retirement accounts – considered account type determination because advice "necessarily includes the advice about the account type into which assets are to be rolled over"
- Advice about account types must
  - Consider all types of accounts offered by the adviser
  - Acknowledge when the account types the adviser offers are not in the client's best interest

Duty of Care

- Prospective Clients
  - General antifraud liability under Section 206 attaches to prospective clients
  - Section 206 requires that advisers have sufficient information about a prospective client and its objectives to form a reasonable basis for advice
  - Once fiduciary relationship is established and the prospect becomes a client, the adviser must also satisfy its fiduciary duty to provide advice that is in the best interest of the client, including for account type

Duty of Care

- Formulation of a reasonable belief that advice is in the best interests of a client with respect to a particular investment requires
  - Consideration of whether a particular investment is consistent with specific client's objectives
  - A reasonable investigation into the investment sufficient not to base its advice on materially inaccurate or incomplete information
  - Evaluation of the cost of the investment, among other factors
    - "When considering similar investment products or strategies, the fiduciary duty does not necessarily require an adviser to recommend the lowest cost investment product or strategy"

Duty of Care

- Account Monitoring
  - Duty of care includes duty to provide advice and monitoring at a frequency that is in the best interest of the client based on the scope of the advisory relationship
  - In the absence of any agreed limitation or expansion, the duty to monitor will be indicated by the duration and nature of the advisory agreement
    - Adviser and client may agree on the frequency of account monitoring
  - Duty to monitor extends to all personalized advice, including an evaluation of whether the account or program type continues to be in the client's best interest
  - Frequency of monitoring is considered a material fact that requires disclosure
  - Monitoring should also be addressed in written policies and procedures under Rule 206(4)-7

Next Steps and More to Come

- Next Steps
- More to Come
  - You can find more analysis, materials, and information about events in our https://www.morganlewis.com/topics/regulation-of-retail-investment-advice.

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Amy J. Greer focuses her practice on securities enforcement and litigation matters. A former regional trial counsel for the US Securities and Exchange Commission's (SEC) Philadelphia office, Amy brings insight from that experience when addressing litigation and investigations by the SEC, the US Department of Justice (DOJ), the US Financial Industry Regulatory Authority (FINRA), and self-regulatory organizations, as well as state attorneys general and securities commissions.

Amy's clients include broker-dealers, investment advisers, hedge funds, mutual funds, securities issuers and reporting companies, and commodities traders. She advises them on allegations of insider trading, financial reporting and accounting claims, fraud allegations related to securities offerings, and investigations into structured and complex products and trading.

She also counsels on Dodd–Frank Act and Sarbanes–Oxley Act issues and handles inquiries concerning sales practices, whistleblower claims, anti-money laundering issues, and violations of the US Foreign Corrupt Practices Act. Amy coordinates efforts with ongoing criminal investigations, multiple enforcement/regulatory efforts, and civil litigation. She also assists clients by conducting internal investigations and providing counsel on regulatory examinations and compliance issues. Given the nature of her practice, Amy often partners with subject matter experts from Morgan Lewis's investment management or labor and employment practices. Amy was recently recognized by *Legal 500* in the Securities Litigation: Defense category.

Prior to joining Morgan Lewis, Amy served as chief litigation counsel at the SEC's Philadelphia regional office and managed a team of lawyers overseeing a wide variety of enforcement matters.

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Jennifer L. Klass is a regulatory counseling lawyer with a broad background in investment management regulation. She advises clients on a wide range of investment advisory matters, including investment adviser registration and interpretive guidance, disclosure and internal controls, regulatory examinations, and enforcement actions. Her clients include major investment banks, investment advisers, broker-dealers, and the sponsors of private investment funds and mutual funds. Previously vice president and associate general counsel at Goldman, Sachs & Co., Jen's practice focuses on the convergence of investment advisory and brokerage services.

Advertising and communications with the public, social media, and fiduciary duty and disclosure are among the securities regulatory areas in which Jen counsels clients. She also advises them on investment adviser registration, internal controls, compliance policies and procedures, separately managed (or wrap fee) programs, regulatory examinations and enforcement actions, interpretive guidance, and no-action requests.

While at Goldman, Sachs, Jen counseled its private wealth management and asset management businesses. She was also previously an associate at Morgan Lewis.

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Daniel R. Kleinman advises businesses on the fiduciary responsibilities provisions (Title I) of the Employee Retirement Income Security Act (ERISA). He also counsels these clients on related tax, corporate, and securities laws in connection with the structuring and marketing of investment products (including private equity and hedge funds) and financial services to employee benefits plans. Additionally, Daniel handles issues related to the regulation of broker-dealers and investment advisers under US federal and state securities laws.

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Christine also counsels financial firms through examinations by industry regulators, as well as on enforcement related matters. Before joining Morgan Lewis, she was an associate at an international law firm in New York and worked for the Division of Enforcement at FINRA.

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Steven W. Stone is a securities lawyer who counsels clients on regulations governing broker-dealers, investment advisers and bank fiduciaries, and pooled investment vehicles. Head of the firm's financial institutions practice, Steve counsels most of the largest and most prominent US broker-dealers, investment banks, investment advisers, and mutual fund organizations. He regularly represents clients before the US Securities and Exchange Commission (SEC), both in seeking regulatory relief and assisting clients in enforcement or examination matters.

Steve advises major US broker-dealers in the private wealth and private client businesses that offer investment advice and brokerage services to high-net-worth clients as well as broker-dealers serving self-directing clients. He also works as counsel on various matters to the Securities Industry and Financial Markets Association's (SIFMA) private client committee and represents most of the best-known US broker-dealers in this area. He also advises broker-dealers and investment advisers in the managed account or wrap fee area, and serves as counsel to the Money Management Institute, the principal trade association focused on managed accounts. Steve also counsels various institutional investment advisers and banks on investment management issues, including conflicts, trading, disclosure, advertising, distribution, and other ongoing regulatory compliance matters.

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Brian J. Baltz focuses his practice on the regulation of investment advisers, broker-dealers, and bank fiduciaries. Brian counsels clients offering investment advice and brokerage services through their private wealth and private client businesses on issues arising under regulation by the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), and Office of the Comptroller of the Currency (OCC). Brian advises investment advisers, broker-dealers, and banks on investment management issues, including conflicts, disclosure, trading, wrap fee programs, soft dollar arrangements, advertising, and other ongoing regulatory compliance matters.

Before joining Morgan Lewis, Brian held multiple positions in the SEC's Division of Trading and Markets, including in the Office of Chief Counsel and Office of Market Supervision. While in the Office of Chief Counsel, he was part of the team responsible for drafting a proposed rule to establish a uniform standard of conduct for broker-dealers and investment advisers. Prior to his work at the SEC, Brian was public policy counsel to a financial services industry trade association based in Washington, DC, where he worked on legislative and regulatory issues impacting broker-dealers and investment advisers, including the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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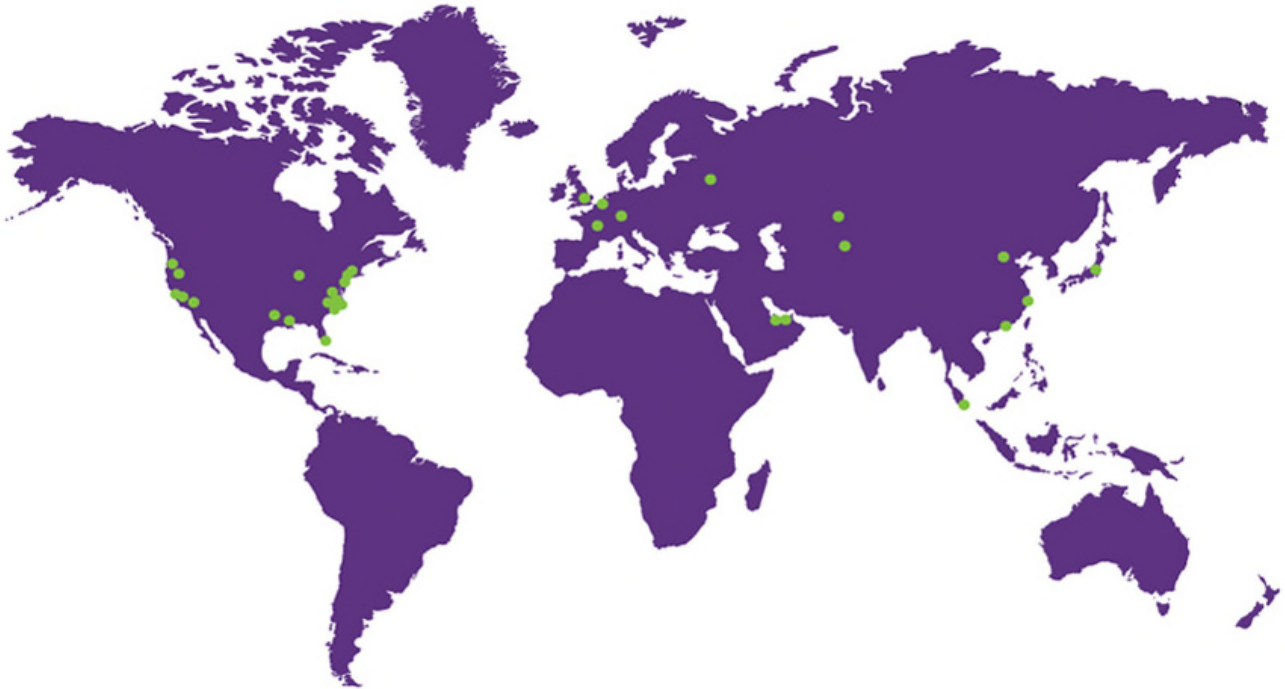

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