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Professional Perspective

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In the long and noisy lead-up to the release of Regulation Best Interest, Exchange Act Rel. No. 34-86031 (June 5, 2019), which established standards of conduct for broker-dealers who recommend securities to retail clients, far fewer voices were heard about the Securities and Exchange Commission's intention to publish a companion piece clarifying the standard of conduct for investment advisers, SEC Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. IA-5248 (June 5, 2019).

While the Interpretation recognizes that advising sophisticated clients may warrant a lighter duty than for Main Street retail clients, concern over declining conduct standards in the private funds sector also inspired the new guidance. Private fund advisers must now consider whether their disclosure practices, compliance policies, governing documents, or contractual terms concerning conflicts of interest comport with this new guidance.

Background

The SEC's concern over the standard of conduct for private fund advisers is rooted in an event many advisers and their counselors have come to take for granted. In 2004, the State of Delaware amended the statutes under which most domestic private funds are organized—the Delaware Revised Uniform Limited Partnership Act and the Delaware Limited Liability Company Act. These amended statutes provide that the general partner of a limited partnership or the manager of a limited liability company may restrict or eliminate its fiduciary duty to limited partners or LLC members in the relevant governing document. Del LP Act §1101(d) and Del LLC Act §1101(c). (Notwithstanding the foregoing, the Del. LP Act and Del. LLC Act specifically provide that the implied contractual covenants of good faith and fair dealing may not be eliminated by contract.)

It is by now common industry practice for private fund governing documents to eliminate a general partner's or managing member's fiduciary duties and provide that it is required to avoid only particularly egregious acts, such as gross negligence or intentional misconduct. In addition, these contracts disclose ever-evolving practices that raise conflicts of interest with the expectation that such disclosure is sufficient to make the conflicted conduct permissible (alone or, with respect to more significant conflicts, with approval of an investor advisory committee or independent directors). This trend is so accepted that investor pushback is minimal, apart from a handful of institutions required by their constitutional statutes or documents to demand something more.

The Interpretation reminds the industry that the federal fiduciary standard cannot be waived, disclosure and client consent must meet certain criteria to be effective, and even full and fair disclosure with consent has limits. While not mentioned in the Interpretation, another development likely contributed to drawing the SEC's attention to private fund standards of care. The Dodd-Frank Act, which precipitated the registration and examination of larger numbers of private fund advisers, can reasonably be assumed to have raised the visibility of private fund advisers' beliefs about their applicable standards of care.

Advisers Are Fiduciaries

The Interpretation was a vehicle for the SEC to restate unequivocally that, under federal law, an investment adviser is a fiduciary to its clients. This is, in fact, the very first sentence of the body of the text. The sources of an investment adviser's duty may be several (those sources include, amongst others, both federal case law and Section 206 of the U.S. Investment Advisers Act of 1940, as amended), but no other sources, whether statutory or contractual, can eliminate the fiduciary duty owed under federal law.

The Interpretation reminds us that Section 206 makes such duties enforceable by the federal government, and applies equally to federally registered advisers, state registered advisers, and advisers exempt from registration.

The federal fiduciary duty arises from common law as a fundamental aspect of an adviser's relationship to its clients (Interpretation, n.15), a principle rooted in congressional intent expressed in the Advisers Act as interpreted by the Supreme Court. Interpretation, n.16, citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

The SEC also reminded the industry that public policy disfavors disclaimers of fiduciary duty. See, for example, the Interpretation, n.19, citing SEC v. Capital Gains, stating that the original bill that became the Advisers Act, declared that "'the national public interest and the interest of investors are adversely affected'" when the business of investment advisers is conducted "'to enable such advisers to relieve themselves of their fiduciary obligations to their clients.'" In addition, an adviser's fiduciary duty "is broad and, once it arises, applies to the entire adviser-client relationship," including conduct that does not specifically involve the purchase or sale of securities. Interpretation, n.17.

The Interpretation explores the constituent duties of care and loyalty. The duty of loyalty is familiar, and "means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own." Interpretation, at 8. The duty of care is given a less common interpretation. The Interpretation does not assert the oft-recited quality standard—namely, the care a reasonable person uses in the management of his or her own affairs. Instead, it cites academic works that focus on the nature of the care required, such that the duty of care requires the adviser "to adopt the client's objectives and goals, for the client is the principal and the fiduciary its agent." Interpretation, at 7–8 and n.22.

While some commenters urged the SEC to codify as regulations the standards proposed for the Interpretation, the SEC instead reaffirmed the value of the current principles-based approach in which written law provides a broad conduct standard flexible enough for the regulator and factfinders to interpret in all variety of contexts. An adviser's fiduciary duty remains a principles-based exception to the predominantly rules-based schemes of most U.S. securities law and regulation.

This year, annual compliance program reviews should consider policies and practices addressing conflicts of interest in light of the Interpretation, especially the articulated standard of care and the reminder that in any dispute involving an adviser's conduct towards its clients, disclaimers of duty may be disregarded as ineffective.

Shaping Fiduciary Duty by Contract

The Interpretation states that fiduciary duty of a private fund adviser may follow "the contours of the relationship" between adviser and client, created by agreement, provided full and fair disclosure informs the client's consent. Interpretation, at 9 and n.26. Still, the existence of the fiduciary duty may not be extinguished. "A contractual provision purporting to waive the adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act, regardless of the sophistication of the client." Interpretation, at 10–11.

To underscore this point, the Interpretation withdraws a prior SEC no-action letter that some commenters interpreted to permit broad fiduciary duty disclaimers in advisory agreements with sophisticated clients. Interpretation, n.31. It did not go so far as to prohibit all attempts to shape "the scope or substance" of the adviser's fiduciary duty with a so-called "hedge clause." Whether the hedge clause violates the Advisers Act (e.g., by misleading the client) will depend on analysis of the relevant facts and circumstances. Also, hedge clauses may create conflicts of interest which the adviser must eliminate or disclose.

Full and Fair Disclosure

The federal duty of loyalty requires advisers to "fully and fairly" disclose all material facts related to the advisory relationship or to conflicts of interest, and to obtain client consent. The Interpretation states that full and fair disclosure is disclosure that is "designed to put a client in a position to be able to understand and provide informed consent to the conflict of interest." Interpretation, at 27.

To be adequate, conflicts disclosure should state how the existence of a hedge clause or other facts limits the adviser's duty or otherwise influences the adviser to render advice that is not disinterested or to engage in conduct that serves its own interests to the detriment of the client's. The adviser's duty is fulfilled only if disclosures are specific enough and accurate enough not to obfuscate whether conflicts actually exist and how conflicts actually are, or will be, addressed.

Inadequate Specificity

The SEC specifically warns that, "disclosure that an adviser 'may' have a particular conflict, without more, is not adequate when the conflict actually exists." Interpretation, at 25. Advisers must be clear about the difference between circumstances that might occur and those that they know will occur. The Interpretation points, for example, to Form ADV instructions that state that if an adviser engages in conflicted practices with respect to some, but not all, clients, advice, or transactions, it should state that a subset is affected, rather than stating that the adviser "may" engage in the practice or "may" have a conflict. Private fund advisers, in their annual review, should confirm that uses of “may” refer only to potential conflicts that do not presently exist but might reasonably arise in the future.

The Interpretation offers additional examples of inadequate specificity. It is not adequate to disclose that an adviser has other clients, without describing actual or potential conflicts among clients, how they arise, and how the adviser addresses them when they arise. Interpretation, at 24. It urges special attention to policies on the allocation of investment opportunities. While acknowledging that an adviser is permitted to consider the differing natures and objectives of its clients, and accordingly, to treat clients differently (even excluding certain clients from certain investment opportunities), the adviser cannot adopt practices that prevent it from providing advice that is in a client's best interests.

Unfair Conduct

Finally, an adviser's actual course of conduct will still be scrutinized. “[Full and fair] disclosure and consent do not themselves satisfy the adviser's duty to act in the client's best interest.” Interpretation, at 23. Thus, the duty to avoid taking unfair advantage of a client's trust persists, even in the category of facts or conduct described by full and fair disclosure. A policy that is adequately disclosed and capable of being applied fairly will not protect an adviser whose actual course of conduct technically complies with its policy but is persistently unfair to one or more clients.

For this reason, in the annual review, private fund advisers will want to revisit disclosures of conflicts policies and the actual practices in which the adviser engaged to implement the policies or mitigate the conflicts. Advisers should confirm that disclosures are sufficiently specific and that actions taken in implementation of disclosed policies are consistent with their fiduciary duties.

Informed Consent

As to consent, an adviser is not required “to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed.”Interpretation, n.68. It is also not necessary for the disclosure and the consent to be in writing or, if in writing, entirely in a single or signed writing. Client consent may be explicit or implied, e.g., by virtue of the client entering into or continuing the advisory relationship.

It is not, however, consistent with an adviser's fiduciary duty to accept or infer consent where the adviser actually is aware, or reasonably should have been aware, that the disclosures were not adequate, or the client did not understand their nature or potential effects.

Impossibility of Disclosure

For private fund advisers whose funds are available to retail investors, it is worth noting that the Interpretation reflects the SEC's view (debated by commenters) that there may be conflicts that are impossible to disclose fairly and fully. “For retail clients in particular, it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable.” Interpretation, at 28. Where it is not possible to provide full and fair disclosure, an adviser should either eliminate the conflict or adequately mitigate (modify practices to reduce) the conflict such that full and fair disclosure and informed consent are possible.

Annual Compliance Program Review

Annual compliance program reviews should examine the uses of hedge clauses to determine whether they are sufficiently narrow, whether disclosure of the conflict raised by a hedge clause is full and fair, and whether any client consent thought to have been obtained is, in fact, effective under the guidance of the Interpretation. It is worth noting that disclosures of this nature may occur not only during the offering and subscription process, but also in connection with events later in a fund's life, including amendments of principal documents, a change of control, admission of a new general partner or managing member, term extensions, and when extraordinary circumstances arise.

The Fund Remains the Client

The Interpretation reaffirms that the client of a private fund adviser is the fund, and it is to the fund that the adviser owes its fiduciary duty.

The Interpretation notes that the duty of care first arises when acquiring and understanding the client's objectives. For a private fund adviser this means having a reasonable understanding of the fund's investment guidelines and objectives, and generally persists without obligation to update its understanding of the client's objectives through additional inquiry, unless required by the advisory agreement. (The duty of care applies to many components of advisory services. This article focuses only on those separately interpreted for the private fund adviser relationship.)

An adviser generally also has a duty to make recommendations that are in its client's best interests. The Interpretation notes that, for a private fund adviser, this means that in addition to staying within the fund's investment guidelines, the adviser must conduct a reasonable investigation into each investment such that its recommendation is not based on materially inaccurate or incomplete information. Accordingly, the annual compliance program review should cover the investment team's due diligence practices.

Other Reminders

Private fund advisers often acquire individual clients when a large investor opens a separately managed account instead of investing in a fund. The Interpretation reminds advisers that certain Section 206 liabilities may attach as a result of their dealings with prospective clients, see Interpretation, n.42, and Rule 206(4)-8 specifically extends certain Section 206 protections to prospective fund investors, even though an eventual investment in a fund would not render them clients of the adviser.

Also, the Interpretation reminds advisers that the duty to seek best execution is determined by seeking to maximize transaction value overall, and not solely by minimizing commissions on the trade. Finally, the SEC notes that an adviser's federal fiduciary duty includes the duty to monitor the client's investments, a duty that may endure for the length of the advisory agreement if it is not specifically otherwise limited. Private fund managers should consider this in the context of policies and procedures affecting actions taken after the end of the fund's stated investment period.

Conclusion

The SEC's Interpretation states that it “does not itself create any new legal obligations for advisers.” Interpretation, at 29. It does, however, require that any adviser that has relaxed its disclosure and compliance practices based on state laws which permit limits on or waivers of fiduciary duties, reconsider those practices and bring them into line with federal fiduciary standards, which cannot be completely waived. In fact, the guidance in the Interpretation has been integrated into the 2020 investment adviser examination program. U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, 2020 Examination Priorities, at 12.

Accordingly, this is an ideal time to take notice of the Interpretation's guidance in connection with a compliance program and ADV reviews and in anticipation of further specific rule changes that may come in 2020.