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FIDUCIARY DUTY

Navigating the Interpretation Regarding an Investment Adviser's Standard of Conduct: What It Means to Be a Fiduciary (Part One of Three)

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On June 5, 2019, SEC Commissioners – by a vote of three to one – published an Interpretation Regarding Standard of Conduct for Investment Advisers (Interpretation), which became effective on July 12, 2019, the date it was published in the Federal Register. The Interpretation was part of a collection of rulemakings and interpretations that also included the adoption of Regulation Best Interest and the Form CRS relationship summary, as well as the publication of an Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser. For SEC-registered investment advisers that advise private funds and other institutional clients, the Interpretation is, by far, the most relevant to their businesses out of this package of regulations and guidance.

This three-part series examines the practical implications of the Interpretation for private fund managers. This first article provides an overview of the Interpretation and explores six key takeaways for fund managers from the Interpretation. The second and third articles will explore how fund managers can adopt a more systematic approach to identify, mitigate and monitor their conflicts of interest in light of the SEC's detailed discussion within the Interpretation regarding an adviser's obligation to "make full and fair disclosure of all conflicts of interest which might incline an investment adviser . . . to render advice which is not disinterested."

See "SEC Chair Defends Regulation Best Interest and Investment Adviser Fiduciary Duty" (Sep. 19, 2019).

Overview of the Interpretation

The Interpretation confirms that an adviser owes its clients a fiduciary duty under Section 206 of the Investment Advisers Act of 1940 (Advisers Act) and that the duty comprises a duty of care and duty of loyalty. Elaborating upon this standard, the SEC stated that an "adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. In other words, the investment adviser cannot place its own interests ahead of the interests of its client."

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Although some commenters to the proposed interpretation – which was published in April 2018 – requested that the SEC adopt a rule setting forth the adviser's standard of care, the SEC declined to do so. Rather, the SEC confirmed that a principles-based approach is appropriate, "as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services."

Application of Duty Determined by Scope of Relationship

Notable to private fund managers, the Interpretation also confirms that an adviser's fiduciary duty follows the scope of that relationship, and the parties "may shape that relationship by agreement." Thus, the SEC recognized that where the contract defines the scope of the adviser's services and limitations on its authority with substantial specificity, the obligations of that adviser will vary significantly from those of an adviser providing ongoing advice to a retail client.

Nevertheless, the relationship between an adviser and a client remains that of a fiduciary, and the SEC specifically stated in the Interpretation that an "adviser's federal fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the relationship." The SEC then provided three specific examples of contract provisions purporting to waive the adviser's federal fiduciary duty that, in its view, would be inconsistent with the Advisers Act, regardless of the level of sophistication of a client:

1. a statement that the adviser will not act as a fiduciary;
2. a blanket waiver of all conflicts of interest; or
3. a waiver of any specific obligation under the Advisers Act.

Finally, in light of the fact that the SEC expressed its views in the Interpretation about when it would be inconsistent with the Advisers Act for an adviser to seek to limit its liability under an advisory agreement (a so-called "hedge clause"), the SEC withdrew the 2007 no-action letter issued to Heitman Capital Management, LLC, in which SEC staff addressed the extent to which hedge clauses may be misleading in violation of the Advisers Act's anti-fraud provisions.

Duty of Care

Although not an exclusive list, the SEC articulated three specific aspects of the duty of care.

1) Duty to Provide Advice That Is in the Best Interest of the Client

In order to provide advice that is in the best interest of its client, the adviser must have a reasonable understanding of the client's objectives. Investment advisers to institutional clients can meet this aspect of the duty of care by adhering to the client's investment mandate. Specifically, the SEC stated that "an investment adviser whose client is a . . . private fund would need to have a reasonable understanding of the fund's investment guidelines and objectives."

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2) Duty to Seek Best Execution

The duty of care also includes a duty to seek best execution when the adviser has the responsibility of selecting a broker-dealer to execute client trades. In articulating this duty, the SEC stated that the adviser must seek to obtain execution such that the client's total costs or proceeds in each transaction are the most favorable under the circumstances. Additionally, the SEC confirmed that in evaluating best execution, the adviser should consider the full range of services provided by the broker-dealer, including research, execution capability, commission rates, financial responsibility and the broker's responsiveness. Finally, the Interpretation confirms that advisers have an obligation, as part of their duty of care, to "periodically and systematically" evaluate the execution that they are receiving for their clients.

See "SEC Adopts Enhanced Order Routing Disclosures: How Fund Managers Should Use These Additional Disclosures Going Forward (Part Three of Three)" (Apr. 11, 2019).

3) Duty to Provide Advice and Monitoring Over the Course of the Relationship

The third aspect of the adviser's duty of care discussed in the Interpretation involves an adviser's obligation to provide advice and monitoring at a frequency that is in the best interest of the client. By way of example, the Interpretation states that when an adviser has an ongoing relationship with a client and is paid a periodic asset-based fee, the "adviser's duty to provide advice and monitoring will be relatively extensive as is consistent with the nature of the relationship."

Duty of Loyalty

The Interpretation describes the duty of loyalty as requiring an adviser to "not subordinate its clients' interest to its own." To meet its duty of loyalty, "an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship."

Although the proposed interpretation stated that "an adviser must seek to avoid conflicts of interest with its clients," the Interpretation published by the SEC clarifies that an adviser may satisfy its duty of loyalty through either (1) the elimination of the conflict; or (2) the full and fair disclosure of the conflict, coupled with the client's informed consent. The SEC then provided guidance in the Interpretation on what constitutes "full and fair" disclosure, specifically discussing the appropriate level of specificity that an adviser should use when disclosing a conflict – including when it would be appropriate to use the word "may" in those disclosures – and considerations for disclosures relating to an adviser's allocations of investment opportunities.

Six Key Takeaways for Private Fund Managers From the Interpretation

Key Takeaway #1: Same Standard but With Greater Specificity

Akin Gump partner Barbara Niederkofler explained that in comparing the SEC's views set forth in the Interpretation to the language in *SEC v. Capital Gains Research Bureau, Inc.* and *Transamerica Mortgage Advisors, Inc. v. Lewis* – both of which are often cited to support

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the notion that Section 206 of the Advisers Act established a federal fiduciary standard to govern the conduct of investments advisers – "the Interpretation is more expansive. For those, however, that have been following the various SEC enforcement actions brought against investment advisers for roughly the past decade, as well as various speeches by members of SEC staff, a lot of these same concepts shine through in the Interpretation."

"The SEC has been signaling over the last five to nine years the different areas and arenas within an adviser's business where a potential conflict may arise; therefore, the Interpretation is more of a summary of many of the same concepts that have already been articulated," added Mayer Brown partner Tram Nguyen. The biggest takeaways from the Interpretation, in Nguyen's view, "are the holistic sense of how conflicts of interest may permeate the alternative investments industry and that advisers need to be vigilant in identifying and addressing those conflicts."

Key Takeaway #2: Interpretation May Have Future Impact on Adviser's Contractual Standard of Care

In articulating an adviser's standard of care, the SEC explained in footnote three of the Interpretation that the standard set forth is intended to highlight how these principles apply to an adviser's fiduciary duty as enforced by the SEC. The Commission acknowledged, however, that the Interpretation is not intended to be the "exclusive resource for understanding these principles," and in fact, case law, statutes and state law also impose obligations on investment advisers, which may "[i]n some cases . . . differ from the standard enforced by the Commission."

The Delaware Revised Uniform Limited Partnership Act permits partners to waive and even eliminate fiduciary duties of a general partner, except for the obligations of good faith and fair dealing, explained Niederkofler. Accordingly, many Delaware funds have adopted broad exculpation provisions whereby the general partner and its affiliates are not liable for any losses sustained by the fund, except for those caused by their gross negligence, fraud or willful misconduct. Although the Interpretation does not expressly meddle with state law, "the Delaware standard does seem at odds with what the SEC has articulated. Therefore, the question becomes, 'In what direction is the industry moving?'" she asked.

Niederkofler explained that, in her practice, she is observing more negotiations between fund managers and investors around fiduciary duty standards – particularly with new fund launches and in side letters. To the extent that the industry continues to move away from the full elimination of fiduciary duties under Delaware law, this is where the Interpretation may have the most significant impact going forward. "It's one thing to have the SEC apply a higher standard to an adviser and be subject to an SEC right of action; it would be quite another to then have investors be able to tack onto that," Niederkofler added.

See "Stanley Druckenmiller's Counsel Provides a Tutorial for Negotiating Exculpation, Indemnification, Redemption, Withdrawal and Amendment Provisions in Hedge Fund Governing Documents" (Feb. 6, 2014).

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Key Takeaway #3: Duty of Care Has Implications As Well

Although the SEC has historically focused more on an adviser's duty of loyalty, the Interpretation makes clear that an adviser's fiduciary duty also entails a duty of care. When it comes to that duty, there are a few notable aspects.

First, in light of the SEC's view that an adviser's understanding of an institutional client's investment objective will be tied to the client's investment mandate, the SEC may pursue style drift claims as alleged breaches of the adviser's duty of care. Thus, advisers should keenly focus on adhering to their clients' investment mandates and seek their informed consent if they want to invest outside of those guidelines.

See "Explicit Disclosure of Changes in Hedge Fund Investment Strategy to Investors and Regulators Is Vital to Reduce Risk of Enforcement Action" (Oct. 29, 2015).

Additionally, in connection with describing the duty of care, the Commission stated in the Interpretation, "We have taken enforcement action where an investment adviser did not independently or reasonably investigate securities before recommending them to clients." Accordingly, advisers should be mindful of the fact that the SEC may scrutinize an adviser's level of due diligence on investments – particularly when those investments perform poorly – under the adviser's duty of care.

Key Takeaway #4: SEC Clarifies Its Expectations Regarding Full and Fair Disclosures

When it comes to meeting its duty of loyalty, an adviser must either eliminate its conflicts of interest or expose them through full and fair disclosure. For some fund managers, certain conflicts are inherent to their business models; thus, eliminating them will not likely be a realistic option. Accordingly, in many cases, advisers will need to ensure that their disclosures concerning those conflicts are full and fair. To that end, the Interpretation provides some helpful guidance.

According to the Interpretation, in order to be full and fair, disclosures will need to "be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent." Therefore, in thinking about how an adviser can draft disclosures that are sufficiently specific, Seward & Kissel counsel David Tang advised that the discussion "should focus on the circumstances that currently exist or will arise that could lead to a conflict between the adviser and its client."

For example, the Interpretation states, "it would be inadequate to disclose that the adviser has 'other clients' without describing how the adviser will manage conflicts between clients if and when they arise . . ." Thus, merely mentioning the fact that the adviser has conflicts because it has other clients does not work under this standard. Rather, Tang noted, the SEC expects the adviser to describe with sufficient specificity (1) who these other clients or types of clients are; and (2) how multiple clients create specific conflicts for

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the adviser. "Furthermore, the adviser should disclose how it manages those conflicts. For example, if it has adopted policies and procedures to manage the allocation of trades among multiple clients, the adviser should describe the key aspects of those policies and procedures," he added.

See our three-part series: "Why Managed Accounts Present Conflicts of Interests for Hedge Fund Managers" (Jul. 18, 2019); "Best Practices for Hedge Fund Managers to Mitigate the Conflicts Arising From Managed Accounts: Dealing With Enhanced Transparency and Liquidity" (Jul. 25, 2019); and "Best Practices for Hedge Fund Managers to Mitigate the Conflicts Arising From Managed Accounts: Dealing With Trade and Expense Allocations" (Aug. 1, 2019).

Also, according to the Interpretation, "Full and fair disclosure for an institutional client . . . can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramification."

"The SEC raises the notion that disclosures for institutional clients could differ from those for retail clients, but it does not offer much guidance on how to resolve the issue," Tang opined. Practically speaking, for purposes of Form ADV, the standard is plain English, and an adviser should not use complicated legalese when simple everyday language is enough to convey the point. He continued, "That standard applies whether the adviser has institutional or retail clients. Conversely, if a more detailed description is required to fully describe a conflict, that detail should be provided, regardless of whether the adviser has retail or institutional clients."

Finally, the SEC delved into when it would – and would not – be appropriate to use the word "may" to describe a conflict. The Interpretation states "the use of 'may' would be inappropriate if it simply precedes a list of all possible or potential conflicts regardless of likelihood and obfuscates actual conflicts to the point that a client cannot provide informed consent." Tang's interpretation of this language is that "the 'kitchen sink' approach does not work when it comes to disclosing conflicts of interest."

On the other hand, according to the Interpretation, it would be appropriate to use the word may to disclose to a client a "potential conflict" that does not currently exist, but "might reasonably present itself in the future." Therefore, if the adviser believes that it is likely that a conflict of interest may arise in the future, it would be appropriate to use the word may to describe that conflict, noted Tang.

Key Takeaway #5: Consent Must Be Informed but Is Not Required to Be Explicit

Although consent from the client must be "informed," advisers are not charged with the duty of making "an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed," the Interpretation explains. Rather, the disclosures must be drafted in a way to put the client in a position to understand the conflict and provide informed consent to the conflict, but a client's informed consent can be either explicit or, depending on the facts, implicit. Practically speaking, Tang explained that it will be a challenge for an adviser to demonstrate

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that it has affirmatively determined that its clients understood the conflicts disclosed in the adviser's Form ADV.

The Interpretation, however, also states that "it would not be consistent with an adviser's fiduciary duty to infer or accept client consent where the adviser was aware, or reasonably should have been aware, that the client did not understand the nature and import of the conflict." Therefore, if a client is telling its investment adviser that it does not understand the conflict, or the adviser otherwise becomes aware that the client does not understand the disclosures, then the client has not provided its informed consent, advised Tang. At that point, representatives from the adviser – which may include compliance, legal and marketing – would need to continue working with the client until they feel reasonably certain that the client understands the conflict and is truly providing informed consent.

Key Takeaway #6: Interpretation May Be Tool for Future Enforcement Actions

Initial reactions from members of the private funds industry suggest that advisers are not expecting the Interpretation to have a material effect on how they conduct their business. Notwithstanding, it will likely be used by the SEC as a basis for future enforcement actions.

Even if the Interpretation had never been finalized, Niederkofler explained, simply by issuing the proposal, the SEC publicly articulated its views on an adviser's standard of care. "Now that the Interpretation has been finalized, we are already seeing specific references to it in enforcement actions and other guidance issued by the SEC, including the Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers that was issued in August 2019," she explained.

Nguyen agreed, adding that "it would not be surprising to see the SEC use all the available tools in its tool kit," which, going forward, will include the Interpretation.

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