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SEC Releases Interpretation of Advisers Act Fiduciary Duties

The SEC recently issued a final interpretation (the "Interpretation")[1] of the federal fiduciary duty that an investment adviser owes to its clients under the Advisers Act. [2]

The SEC thought it would be beneficial to address in one release and reaffirm, and in some cases clarify, its understanding of certain aspects of the fiduciary duty. The SEC does not regard the Interpretation as new rulemaking or as the exclusive resource for understanding an investment adviser's fiduciary duty, but rather views it as a summary of existing law in the area. While many practitioners may disagree with that assessment on various individual points in the Interpretation, the overall fiduciary duty described in the Interpretation is one that private fund advisers will find to be generally in line with their prior understandings.

The following are certain highlights of the Interpretation of particular relevance for private fund advisers.

- ***Full and Fair Disclosure***. The Interpretation emphasizes that pursuant to an investment adviser's duty of loyalty, it must either eliminate conflicts of interest or provide full and fair disclosure that is specific enough to enable the client to "understand the material fact or conflict of interest and make an informed decision whether to provide consent." The Interpretation identifies the following as circumstances, among others, in which disclosure would not be full and fair:
  - *"May" Disclosures*. Consistent with other recent statements from the SEC, the Interpretation emphasizes that disclosures stating that an investment adviser "may" have a particular conflict would not be adequate if the conflict actually exists. The Interpretation specifies that the use of a "may" disclosure would be inappropriate: (i) where a conflict actually exists in some, even if not all, of the circumstances being described, unless additional disclosure specifies the circumstances in which the conflict actually exists; and (ii) if it precedes a laundry list of possible or potential conflicts, obscuring actual conflicts that exist. However, the Interpretation states that the word "may" could be appropriately used to disclose a "potential conflict that does not currently exist but might reasonably present itself in the future."
  - *Disclosure of Practices Inconsistent with Acting in the Client's Best Interests*. The Interpretation notes that the duty of loyalty, and the corresponding obligation to make full and fair disclosure of conflicts of interest, is a part of, and not an exception to, the duty to act in the client's best interest.

[1] "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (June 5, 2019).

[2] The Investment Advisers Act of 1940, as amended (the "Advisers Act").

- *Conflict Management*. The Interpretation notes that the inherent nature of certain conflicts of interest (e.g., those involving complex conflicts) may not be addressed simply by describing the conflict alone, but that the disclosure would also need to describe how the investment adviser will manage it. Consistent with the general theme of the Interpretation, ensuring that any such disclosures address the manner in which the underlying conflict will be managed would further support the position that the investment adviser provided full and fair disclosure for purposes of informing a client's consent.

- ***Dual-Registered Investment Advisers***. The Interpretation notes that investment advisers that are also registered as broker-dealers and who serve the same clients in both capacities should be particularly sensitive to ensuring full and fair disclosure to their clients about the circumstances in which they intend to act in each capacity.

- ***Hedge Clauses***. The Interpretation withdraws the Heitman No-Action Letter,[3] which held that hedge clauses (i.e., clauses limiting the liability of an investment adviser under an advisory agreement with its client) could be misleading and therefore violate the anti-fraud provisions in §206(1) and §206(2) of the Advisers Act absent clear language that the client was not waiving claims not permitted to be waived under applicable law. In withdrawing the Heitman No-Action Letter, the Interpretation expressly provides that the question of whether a "hedge clause" violates the anti-fraud provisions of the Advisers Act depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (e.g., sophistication). It is unlikely that the SEC's withdrawal of the Heitman No-Action Letter presents a meaningful change for most private fund advisers.

- ***Sophistication of Private Fund Clients***. The Interpretation repeatedly acknowledges that the analysis of an investment adviser's fiduciary duty is determined on a facts and circumstances basis, which will generally result in the fiduciary duty being applied differently with respect to services provided by an investment adviser to a sophisticated client, as compared to services provided by an investment adviser to a "retail client" (a concept that remains undefined in the Interpretation).

  - Specifically, the Interpretation acknowledges that "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."

  - The Interpretation does not address the SEC's view regarding the sophistication of retail investors investing in private funds, but investment advisers to private funds with retail investors should consider their disclosures in light of the general principles discussed in the Interpretation.

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3 Heitman Capital Management, LLC, SEC Staff No-Action Letter (Feb. 12, 2007).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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