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# A Private Fund Manager's Guide to the SEC's 'Standard of Conduct' Release

The Securities and Exchange Commission recently adopted a package of new rules and interpretations, including Regulation Best Interest (**Reg BI**), the Form CRS Relationship Summary (**Form CRS**) and guidance[1] on the Investment Advisers Act of 1940 (the **Advisers Act Guidance** or **Release**). This Client Alert will focus on the Advisers Act Guidance, which is applicable to both advisers fully registered with the SEC and exempt reporting advisers who manage only private funds.[2] The following is a brief discussion of certain aspects that may be relevant to private fund managers.

More information on Reg BI, which is applicable only to broker-dealers, and Form CRS, which is applicable only to broker-dealers and investment advisers[3] that enter into advisory contracts with "retail" investors, can be found in separate Client Alerts [Risk&Reward-June Edition (https://www.stradley.com/insights/publications/2019/06/risk-and-reward-june-6-2019) and Risk&Reward-July Edition (https://www.stradley.com/insights/publications/2019/07/risk-and-reward-july-1-2019)].

With the Advisers Act Guidance, the SEC aims to "reaffirm – and in some cases clarify – certain aspects of" an adviser's fiduciary duty under the Advisers Act, namely the duty of care and duty of loyalty all advisers owe their clients. Of particular importance to private fund managers are the SEC's general focus on the duty of loyalty as it relates to disclosure of material facts about conflicts of interest, and the SEC's specific discussion of conflicts associated with allocation of investment opportunities among clients, including co-investments, each of which we cover below. In addition,

we highlight a recent enforcement case involving a U.K.-based hedge fund manager that underscores certain of the themes from the Advisers Act Guidance.

**Duty of Loyalty**

The Release lays out the SEC's view that "[u]nder its duty of loyalty, an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest … such that a client can provide informed consent to the conflict."

***Disclosure and Informed Consent***

The Release is not prescriptive with respect to how an adviser must disclose any conflicts and obtain informed consent from clients, but it does note that consent need not be in a written agreement. Rather, an adviser's "client could implicitly consent by entering into or continuing the investment advisory relationship," after receiving "a combination of Form ADV and other disclosure." Although offering memoranda are not specifically referenced in the Advisers Act Guidance, SEC staff has suggested in the past[4] that such disclosure may include a private fund's offering memorandum.

Nor is the Release prescriptive in terms of the format and content of the disclosure, although the SEC clearly differentiated between an adviser's obligations with respect to institutional clients (e.g., a private fund) and "retail" clients, noting that what constitutes full and fair disclosure "can differ, in some cases, significantly" between the two audiences.[5] The key, however, is that "regardless of the nature of the client, the disclosure must be clear and detailed enough for the client to make an informed decision to consent to the conflict of interest or reject it."

***Specificity of Disclosure and Appropriateness of Use of 'May'***

The Release does, however, provide examples of disclosure practices that the SEC considers inadequate or inappropriate, with a particular focus on use of the word "may." Citing past enforcement actions, the SEC points out that "disclosure that an adviser 'may' have a particular conflict, without more, is not adequate when the conflict actually exists.... In addition, 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." In terms of level of detail, the guidance notes that it would be insufficient simply to disclose that an adviser "has 'other clients' without describing how the adviser will manage conflicts between clients if and when they arise or to disclose that the adviser has 'conflicts' without further description." Managers should take note of the above and review their firm's disclosure for appropriate use of the word "may."

***Allocation of Investment Opportunities Including Co-Investments***

One specific area of potential conflicts of interest that the Release discussed is an adviser's allocation policies and the obligation to describe "how the adviser will allocate investment opportunities, such that a client can provide informed consent." In this way, the Release echoed in part the SEC's Office of Compliance and Inspections (**OCIE**) 2019 Examination Priorities,[6] which noted that OCIE plans to "review firms' practices for … fairly allocating investment opportunities among clients," and for "disclosing critical information to clients...."

For private fund managers, such allocation conflicts could arise in various contexts, for example, trade allocations among client accounts that have overlapping investment mandates, including a managed account run *pari passu* to a flagship fund, or a long-only fund that has been "carved out" from a flagship long/short fund. In addition, conflicts of interest could arise in the allocation of co-investment opportunities among clients, as suggested by the acting director of OCIE in a 2015 speech: "Co-investment opportunities have a very real and tangible economic value but also can be a source of various conflicts of interest," and given that, "all investors deserve to know where they stand in the co-investment priority stack."[7] While on the enforcement front the SEC's recent focus has primarily been on private equity managers' practices with regard to allocation of fees and expenses associated with co-investments among clients,[8] managers should take note of this increasing focus on co-investments more broadly, and should review their practices with respect to allocation of opportunities and relevant disclosure.

In terms of the content of allocation policies, the SEC clearly states that opportunities need not be allocated *pro rata*, noting further that "[a]n adviser and a client may even agree that certain investment opportunities or categories of investment opportunities will not be allocated or offered to a client" (emphasis added). The SEC's use of the word "agree" in this context is a reminder of its expectation that an adviser's "fiduciary duty follows the contours of the relationship … and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."

***Enforcement***

In 2016, the SEC brought an enforcement proceeding[9] against a U.K.-based hedge fund manager that highlights certain of the themes discussed above. In that case, the SEC alleged that the manager failed to inform investors in its existing flagship fund of the "significant overlap" in trade allocations between that flagship fund and a newer vehicle, which was marketed as having a divergent investment strategy. The SEC cited, among other things, the fact that the manager "never updated" the offering documents of the flagship fund, which disclosed that the manager "may manage additional funds in the future that may invest in the same markets as [the flagship fund] and certain conflicts of interest could result." Further, the SEC alleged that the manager and its founder "should have, but did not, update the [due diligence questionnaire] response they provided to many existing and prospective [flagship fund] investors about [the new vehicle]," which continued to position the two funds as having separate strategies despite the "high degree of overlap" between their investments.

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**Duty of Care**

In addition to its discussion of advisers' duty of loyalty, the Release also describes advisers' duty of care, including the duty to seek best execution and the newly described "duty to provide advice and monitoring." With respect to best execution, the Release is consistent with prior SEC guidance and serves as a reminder of advisers' obligations not only to seek best execution in selecting counterparties to execute trades on behalf of clients, but also to "periodically and systematically" evaluate such providers. Further, the Release lays out a newly described obligation to "monitor" client accounts, which should be "at a frequency that is in the best interest of the client, taking into account the scope of the agreed relationship." While the SEC provides no specific guidance in terms of expectations with respect to private fund clients, all advisers may want to consider how best to document satisfaction of their duty to monitor client accounts. The Release further suggests that registered investment advisers "may consider whether written policies and procedures relating to monitoring would be appropriate."

Given that the Release is immediately effective, below are certain questions that private fund managers may wish to consider in light of the SEC's focus on these issues:

- Have you reviewed the Conflicts of Interest disclosure in your fund offering documents and/or Form ADV, Part 2A, for appropriate use of the word "may"?
- Do you have a written investment allocation policy, and are you following it and documenting any deviations therefrom?
- Does your firm participate in co-investments, and if so, have you disclosed your policy (and any updates) to investors?
- Do you have a process and documentation in place to substantiate your firm's "duty to monitor" client accounts?

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[1] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. IA-5248 (https://www.sec.gov/rules/interp/2019/ia-5248.pdf) (June 5, 2019).

[2] The Advisers Act Guidance also applies to any managers relying on the "foreign private adviser" exemption of Section 202(a)(30) of the Advisers Act (**Foreign Private Advisers**), generally those with fewer than 15 U.S. clients and 15 U.S. investors in private funds as well as less than $25 million attributable to such U.S. clients and investors.

[3] Note that Form CRS is also applicable to Foreign Private Advisers, but only to the extent of any advisory contracts with U.S. "retail" investors. A "retail" investor for purposes of Form CRS includes any natural person, without regard to net worth or sophistication. Note, however, that Form CRS does not "look through" to underlying investors in pooled investment vehicles such as hedge funds or mutual funds, such that it will not impact managers of only such vehicles, or those who advise institutional clients, such as separately managed accounts with endowments or pension funds.

[4] Julie Riewe, co-chief, Asset Management Unit, Division of Enforcement, SEC, "Conflicts, Conflicts, Everywhere (https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html)" (Feb. 26, 2015); *see also* In re James Caird Asset Management LLP and Timothy G. Leslie, Investment Advisers Act Release No. 4413 (https://www.sec.gov/litigation/admin/2016/ia-4413.pdf) (June 2, 2016).

[5] The Release notes that "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."

[6] OCIE, SEC, Examination Priorities for 2019 (https://www.sec.gov/files/OCIE%202019%20Priorities.pdf?_sm_byp=iVVR5QHVPLs3n1DF) (Dec. 20, 2018).

[7] Marc Wyatt, acting director, Office of Compliance Inspections & Examinations, SEC, "Private Equity: A Look Back and a Glimpse Ahead (https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html?_sm_au_=iVVTV43DJ5SFNMfFCQttjK3TfG3J0)" (May 13, 2015).

[8] In re Lightyear Capital LLC, Investment Advisers Act Release No. 5096 (https://www.sec.gov/litigation/admin/2018/ia-5096.pdf) (Dec. 26, 2018); and In re Kohlberg Kravis Roberts & Co. L.P., Investment Advisers Act Release No. 4131 (https://www.sec.gov/litigation/admin/2015/ia-4131.pdf) (June 29, 2015).

[9] In re Caird (https://www.sec.gov/litigation/admin/2016/ia-4413.pdf) (June 2, 2016).