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The SEC's Private Fund Adviser Rules Explained

Part 3: Deciphering a Private Fund Manager's Fiduciary Duty

By Scott H. Moss, David L. Goret, Louise Gong, and Zachary D. Furnald

On August 23, 2023, the Securities and Exchange Commission (SEC) adopted new rules and amendments under the Investment Advisers Act of 1940, as amended (the Advisers Act), that are expected to have a wide-ranging impact on private fund managers. We refer to these rules collectively as the "Private Fund Adviser Rules."[1] We discussed the rules in a recent Client Alert and subsequently expanded on the requirements of these rules in a Client Alert on Rule 211(h)(2)-1 (Restricted Activities Rule) and a Client Alert on Rule 211(h)(2)-3 (Preferential Treatment Rule).

Aside from understanding the Private Fund Adviser Rules themselves, private fund managers must also understand what the Private Fund Adviser Rules' adopting release (Adopting Release) states about the SEC's current interpretation of the fiduciary duty private fund managers owe to their fund clients and other clients. Importantly, the SEC's interpretation of the fiduciary duty of private fund managers in the Adopting Release appears to significantly expand upon the SEC's 2019 interpretation (Interpretation) on the standard of conduct for investment advisers.[2]

While the SEC did not adopt certain proposed rules prohibiting a private fund manager from (i) seeking reimbursement, indemnification, or exculpation for simple negligence and breach of fiduciary duty and (ii) charging fees for unperformed services in adopting the Private Fund Adviser Rules, the Adopting Release makes clear that the SEC deems such conduct to constitute a de facto violation of a private fund manager's fiduciary duty and/or the Advisers Act anti-fraud rule.

The Adopting Release suggests greater flexibility for the SEC to interpret and enforce the fiduciary duty of private fund managers, hence shifting the battlefield from rulemaking to examination and rulemaking by enforcement.

Fiduciary Duty in the Adopting Release

(i) Scope of Fiduciary Duty

The Adopting Release reaffirms that the Advisers Act establishes a federal fiduciary duty for investment advisers (including private fund managers) that is comprised of a duty of care and a duty of loyalty.[3] This duty is imposed by Section 206 of the Advisers Act.[4] The SEC states that in order to satisfy its fiduciary duty, an adviser must act in the fund's best interest and make full and fair disclosure to its clients (and the investors therein) of all conflicts and material facts associated with an adviser-led transaction. According to the Adopting Release, "full and fair disclosure" should be sufficiently specific in order for a client to be able to understand the material fact or conflict of interest and make an informed decision on whether to provide consent.

(ii) Improperly Charging Fees and Misallocating Expenses

The Adopting Release cites numerous enforcement actions against private fund managers engaged in "problematic practices" that are contrary to an adviser's federal fiduciary duty and/or violate the anti-fraud provisions of the Advisers Act, such as when a private fund manager (a) incorrectly or improperly

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[1] The full text of the Private Funds Rules is available beginning on page 644 of the Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-6368 (Aug. 23, 2023) (defined herein as the "Adopting Release"), which can be found here.

[2] On June 5, 2019, the SEC adopted a comprehensive interpretation of the fiduciary duty that investment advisers owe to their clients under the Advisers Act. See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) (the "Interpretation") which can be found here.

[3] See pages 250-251 of the Adopting Release. The fiduciary duty is based on equitable common law principles that are interpreted through a series of case law and SEC statements and enforcement actions.

[4] See page 28 of the Adopting Release, where the SEC states that it is "a proper exercise of [the SEC's] rulemaking authority under [Sections 206 and 211(h) of] the Advisers Act to prevent fraudulent, deceptive, and manipulative conduct, facilitate the provision of simple and clear disclosures to investors, and prohibit or restrict certain sales practices, conflicts of interest, and compensation schemes."

charges fees and expenses to a private fund client, (b) misallocates fees and expenses between its private fund clients and away from itself, (c) fails to disclose fees in the form of undisclosed accelerated monitoring fees and discounts on legal fees, (d) mischarges a performance fee to a private fund client contrary to investor disclosures, or (e) fails to offset certain fees or other amounts against management fees as set forth in fund documents.[5] Furthermore, the SEC states that private fund managers cannot charge funds for fees and expenses that are not permitted under its governing documents, as such actions are inconsistent with the adviser's fiduciary duty and may violate the anti-fraud provisions of the Advisers Act.[6]

(iii) Fees for Unperformed Services

The SEC did not adopt a proposed rule that would have expressly prohibited a private fund manager from charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the private fund manager does not (or does not reasonably) expect to provide. According to the Adopting Release, because such conduct would violate an adviser's fiduciary duty in any event, the SEC viewed as unnecessary a new rule that would prohibit activity that is "already inconsistent with the adviser's fiduciary duty."[7] The SEC warns that "as a fiduciary," an adviser "may not keep prepaid advisory fees for services that it does not, or does not reasonably expect to, provide to a client." Charging fees for unperformed services to a portfolio investment in the SEC's opinion is tantamount to indirectly charging those fees to the fund.

(iv) Limitation of Liability and Indemnification

The Private Fund Adviser Rules also dropped a contentious proposal that would have prohibited private fund managers from seeking, directly or indirectly, reimbursement, indemnification, exculpation, or limitation of their liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund (also known as hedge clauses). Instead, the SEC stated that an explicit prohibition is superfluous and reiterated its position that a contractual provision purporting to waive or otherwise contract away an adviser's federal anti-fraud liability for breach of fiduciary duty to a private fund client, or of any other provision of the Advisers Act, is invalid.[8]

In the Interpretation, the SEC posits that there are few (if any) circumstances in which a hedge clause with a retail investor would be consistent with the anti-fraud provisions, whereas for institutional clients, that determination depends on the facts and circumstances (including the sophistication of the client and the scope of the contractual relationship). The Adopting Release appears to go beyond the Interpretation, stating that, to the extent a hedge clause creates a conflict of interest between a private fund manager and its client, the private fund manager "must address the conflict as required by its duty of loyalty" (i.e., without regard to the sophistication of the client).

In the SEC's view, a hedge clause with an institutional client is violative of the Advisers Act's anti-fraud provisions if such clause (a) waives any and all of the adviser's fiduciary duty or (b) "explicitly or generically" waives the adviser's federal fiduciary duty, and in each case there is no "savings clause" language to the effect clarifying that the adviser is not waiving its federal fiduciary duty or that the client retains certain non-waivable rights. Further, any reimbursement, indemnification, or exculpation sought by an adviser for breaching its federal fiduciary duty is prohibited, as the SEC views such reimbursement, indemnification, or exculpation as effectively constituting a waiver, which would be invalid under the Advisers Act. This could mean that an advisory agreement providing for indemnification of a private fund manager for conduct (such as simple negligence, as has been the predominant standard in the industry for decades) is a waiver of and conflicts with the adviser's fiduciary duty and is therefore invalid under the Advisers Act.

The SEC further clarified that to the extent a waiver clause is unclear as to whether it applies to federal fiduciary duty, state fiduciary duty, or both, the SEC will interpret the clause as waiving the federal fiduciary duty, and therefore the clause is impermissible.

(v) Advisers of Managed Accounts

While not expressly addressed in the Private Fund Adviser Rules, the SEC also states that a private fund manager cannot disadvantage its fund clients in favor of its managed accounts clients, as the fiduciary duty owed by the adviser to all of its clients protects against such preferential treatment.

(vi) Obligations of Offshore Private Fund Managers

For offshore private fund managers, the Private Fund Adviser Rules do not extend to activities with respect to the private fund manager's offshore private fund clients, even if the offshore funds have U.S. investors. However, the Private Fund Adviser Rules still apply to offshore private fund managers managing U.S.-domiciled funds (even where there are no U.S.

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[5] See pages 14-15, 63, and 75-76 of Adopting Release, where the SEC cites enforcement actions against private funds it has pursued for fraudulent practices related to fee and expense charges or allocations that are influenced by the advisers' conflicts of interest and failing to disclose material conflicts of interest.
[6] See pages 209 and 234 of the Adopting Release.
[7] See page 251 of the Adopting Release.
[8] See page 255 of the Adopting Release.

investors). Notwithstanding the foregoing, the SEC's fiduciary duty commentary in the Adopting Release is still relevant to offshore managers, even those to which the Private Fund Adviser Rules do not apply, because the fiduciary duty applies to all investment advisers subject to the SEC's jurisdiction.

Our Thoughts

Although the SEC does not view the Private Fund Adviser Rules to impose any **new** fiduciary obligations, the SEC's interpretation of fiduciary duty in the Adopting Release is expressly broad and could potentially lead to backdoor rulemaking by enforcement. Private fund managers preparing for the Private Fund Adviser Rules to become effective should be mindful of the following: (1) contract provisions in the governing documents of its funds that purport to waive, in whole or in part, the private fund manager's federal fiduciary obligations or any specific obligations under the Advisers Act are inconsistent with an adviser's fiduciary duty for retail and institutional clients alike and may need to be amended; (2) a breach of fiduciary duty may arise from simple negligence alone; (3) any savings clause in fund documents that purports to disclaim a private fund manager's fiduciary duty should be amended to comply with the commentary by the SEC surrounding the new rules; and (4) contract provisions governing fees, including accelerated monitoring fees, may themselves be a breach of fiduciary duty and will need to be modified in the fund documents. Private fund managers that also advise managed accounts should also examine whether managed account terms, including terms related to liquidity and transparency, could disadvantage any fund employing a similar strategy (and whether related advisory agreements need to be revised accordingly).

Perhaps most importantly, with the adoption of the new rules, it will be interesting to see if the SEC uses its enforcement powers to narrow the long-standing indemnification standard that has protected private fund managers for decades to a more investor-friendly standard in accordance with the SEC's more explicit and broadened definition and scope of a private fund manager's fiduciary duty.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

SCOTT H. MOSS
Partner
Chair, Fund Regulatory & Compliance
Co-chair, Investment Management Group
T: 646.414.6874
smoss@lowenstein.com

DAVID L. GORET
Partner
T: 646.414.6837
dgoret@lowenstein.com

LOUISE GONG
Counsel
T: 646.414.6931
lgong@lowenstein.com

ZACHARY D. FURNALD
Associate
T: 862.926.2791
zfurnald@lowenstein.com