SEC Clarifies Fiduciary Duty of Private Equity Fund Managers

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SEC CLARIFIES FIDUCIARY DUTY OF PRIVATE EQUITY FUND MANAGERS
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The Securities and Exchange Commission (SEC) recently published its interpretation (the "Interpretation")[1] of the standard of conduct applicable to investment advisers – including managers of private funds. The Interpretation reaffirms and clarifies the SEC's position on the fiduciary duty of investment advisers. This article will discuss some of the fiduciary duties specifically applicable to private equity fund managers and their affiliates.

Most private fund managers, regardless of whether they are registered with the SEC or not, have a fiduciary duty to their clients under the Investment Advisers Act of 1940 (the "Advisers Act").[2] Although the Advisers Act does not specify a standard of conduct applicable to investment advisers, Section 206 of the Act has been interpreted through case law and SEC guidance over the years to impose a fiduciary duty on investment advisers without defining the full scope of this duty.

The Interpretation lays out the components of an adviser's fiduciary duty, clarifies that it comprises both a duty of loyalty and a duty of care, and that it is applicable to all investment advisers, whether registered under the Advisers Act, state law, or not at all. The Interpretation also confirms that an adviser's fiduciary duty *may not* be waived, but the applicable standard of conduct may be modified depending on the sophistication of the client and the services being provided by the investment adviser. Although the Interpretation primarily focuses on investment advisers generally, the SEC makes clear that private fund managers also have both a duty of care and a duty of loyalty to the funds they manage.

Duty of Care. The duty of care of private fund managers includes, among other things: (i) the duty to perform adequate due diligence on the fund's investments, (ii) the duty to manage the fund's investment in the best interest of the fund, and (iii) the duty to carefully monitor the fund's investments throughout the term of the fund. This requires the manager to follow the fund's investment strategy as outlined in the fund's offering documents and to have a reasonable belief that each investment is in the best interest of the fund based on these objectives.

Duty of Loyalty. The duty of loyalty requires that a private fund manager serve the best interest of the fund and not subordinate the fund's interest to those of the manager or its affiliates. To fulfill this duty, the sponsor of the fund must make full and fair disclosure to prospective investors of all material facts relating to each conflict of interest. The manager must eliminate to the extent possible, or expose through specific disclosure, each conflict. This disclosure must be sufficiently specific to allow investors to make an informed decision whether to invest in the fund.

For a closed-end fund, such as a private equity fund, these disclosures should be made in the private placement memorandum (PPM) to the extent possible. The SEC makes clear that the PPM must specify each conflict of interest and how that conflict will be addressed. For example a disclosure that there may be conflicts of interest would not be sufficient. Instead, the PPM should disclose which conflicts exist at the time of the offering with enough specificity to allow investors to make an informed decision on whether to invest.

Conflicts of interest that arise during the term of the fund are tricky since a private equity fund does not allow investors to vote with their feet by withdrawing during the term of the fund. Those conflicts must be eliminated, or mitigated in a way that meets the manager's fiduciary duty. It may not be practical to obtain the consent of each limited partner every time a conflict comes up. Best practice is to form an independent limited partner advisory committee (LPAC) to provide advance consent to each related party transaction and any other transaction that creates a conflict between the interest of the fund and those of the manager or its affiliates.

Examples of undisclosed conflicts of interest that have led to sanctions and substantial monetary penalties against private equity fund managers include (i) charging the fund for management, legal, or accounting expenses performed by an affiliate, (ii) accelerating portfolio monitoring fees, and (iii) allocating investment opportunities to a co-investment vehicle or another fund. Of course, full and fair disclosure in the PPM or the informed consent of an uninterested LPAC would mitigate these conflicts.

What constitutes full and fair disclosure will depend on the sophistication of the investors in the fund. For example, a conflict may be so complicated that it would be impossible to disclose it in a manner that would allow an unsophisticated investor to make an informed decision whether to invest. In this case, the conflict must be eliminated or adequately mitigated and disclosed in an understandable way that allows informed consent of all investors. As an alternative, the informed consent of the LPAC will be sufficient if the LPAC is independent of the manager and its affiliates, and is well informed.

No Waiver of Fiduciary Duty. The Interpretation makes clear that an agreement to completely waive an adviser's fiduciary duty, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts, or (iii) a waiver of any specific obligation under the Advisers Act, is inconsistent with the Advisers Act and may be a violation of law. Having a waiver of fiduciary duty in the fund's offering documents can lead to liability for the general partner or sponsor of the fund.

Although an adviser’s fiduciary duty cannot be completely waived, the SEC acknowledges that the adviser and client can shape their relationship by contract, depending on the sophistication of the client, and whether there is full disclosure and informed consent. For a private fund, whether informed consent can be given depends on the nature of the investors. Most investors are not in a position to negotiate the terms of the fund’s governing documents. On the other hand, if a fund is limited to sophisticated institutional investors that have sufficient leverage to negotiate the terms of the fund’s partnership agreement, the investors could agree to a standard of conduct applicable to the manager of the fund and its affiliates. For example, the Interpretation questions whether a retail investment advisory agreement could limit the adviser’s liability for its own negligence, but implies that a private equity fund partnership agreement could use a gross negligence standard. Presumably this would depend on the negotiating power and sophistication of the fund’s investors.

TAKEAWAYS

• Disclose specific conflicts of interest in the PPM if possible.
• Form an independent LPAC to approve related party transactions that can’t be disclosed in the PPM.
• Do not include a waiver of fiduciary duty in the fund documents.
• Do specify the standard of conduct applicable to the general partner, the manager, and their affiliates.
• Consult qualified legal counsel regarding mitigation of conflicts of interest.

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1. SEC Release IA-5248.
2. The Advisers Act may not apply to managers of certain funds, for example those that make direct investments in real estate or those that operate oil and gas interests, rather than passive investments in those assets. Managers of all private funds are urged to consult legal counsel regarding the applicability of the Advisers Act and other securities laws.