

Professional Perspective

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Douglas I. Koff, Charles J. Clark, Derek N. Lacarrubba & J. Eric Prather,
Schulte, Roth & Zabel

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Contributed by [Douglas I. Koff](#), [Charles J. Clark](#), [Derek N. Lacarrubba](#) & [J. Eric Prather, Schulte, Roth & Zabel](#)

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Under U.S. Securities and Exchange Commission Chair Gary Gensler, the SEC has returned to an aggressive enforcement posture. Specifically, since 2021, actions by the SEC's Division of Enforcement demonstrate the commission's desire to reshape the regulatory landscape by bringing novel enforcement actions and signaling its intent to aggressively use enforcement powers to curtail long standing industry practices.

Of particular focus are perceived failures to adequately identify and mitigate conflicts of interest. Gensler has suggested that existing rules may not sufficiently address conflicts of interest, and on Feb. 9, 2022, the commission proposed new rules to address these deficiencies. Moreover, the enforcement division has brought a series of novel enforcement actions against investment advisers related to conflicts of interest—announcing three new enforcement actions in March 2022 alone.

This flurry of activity evinces the rapidly evolving enforcement and regulatory landscape, raising the specter that the commission's rule proposals are a lagging indicator of the type of adviser conflict issues that the enforcement division intends to aggressively target.

Going forward, we expect the commission's enforcement agenda to further accelerate, and advisers to face renewed scrutiny for conflicts of interest, including of long-standing practices. Similar to previous eras of increased enforcement activity, the commission may not just aggressively target clear rule violations but may press the boundaries of its enforcement authority, including areas where the commission previously gave comfort to the adviser community.

As discussed further below, the enforcement division may focus on conflicts arising from advisers' interlocking relationships with companies in which they hold ownership interests, other funds in which the advisers have an interest, and the advisers' limited partners. Due to the complexity of these arrangements and the interwoven interests of each party, advisers should carefully assess their economic distribution, management, disclosure, and information transfer practices to ensure that all parties are receiving full and fair disclosure of actual and potential conflicts.

Advisers' Fiduciary Duties Under the Advisers Act

Since at least 1963, the SEC's position has been that Advisers are subject to federal fiduciary standards in their client interactions. See, e.g., *SEC v. Cap. Gains Rsch. Bureau, Inc.* 375 U.S. 180, 189-94 (1963); *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 36 (1979). The federal fiduciary duty is not found within the [Investment Advisers Act](#) of 1940, as amended, (the Advisers Act), but was established through a commission opinion recognizing an "affirmative obligation [for an adviser] to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent." *In re Arleen W. Hughes*, Exch. Act Rel. No. 34-4048 (Feb. 18, 1948), *aff'd sub nom Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949).

The court, in *Cap. Gains*, held that the Advisers Act "empowers the courts . . . to require an [A]dviser to make full and frank disclosure of [its] practice[s]," and "requires [the adviser's] advice be disinterested." The court's interpretation was grounded in the anti-fraud provisions of the Advisers Act, the relationship between advisers and clients, and Congress' intent to eliminate or expose all conflicts of interest that may prevent an adviser from providing disinterested advice.

From the early decisions in *Hughes* and *Cap. Gains*, courts and the SEC have continued to address advisers' fiduciary duties through court rulings, administrative actions, settlements, and interpretive guidance. See, e.g., *Transamerica*; *Proxy Voting by Investment Advisers*, Adv. Act Rel. No. 2106 (Jan. 31, 2003).

SEC Interpretive Guidance

In 2019, the SEC adopted an [updated interpretation](#) of the federal fiduciary duty, clarifying its views on advisers' fiduciary obligations. The interpretation makes clear that, in the SEC's view, the federal fiduciary duty, encompassing duties of care and loyalty, requires an adviser to place its clients' interest first, never subordinating them to the adviser's own. In accordance with this duty, an adviser must "make full and fair disclosure to its clients of all material facts relating to the advisory relationship," including an [ongoing obligation](#) to timely disclose all relevant material information to clients.

With regard to conflicts between the adviser and clients, the interpretation requires advisers to "eliminate or make full and fair disclosure of all conflicts of interest which might incline an [adviser] - consciously or unconsciously - to render advice which is not disinterested such that [an adviser can obtain informed client consent]." Accordingly, the SEC will very carefully scrutinize conflicts between an adviser and its clients.

Where it is impractical to eliminate actual or potential conflicts, the interpretation requires "full and fair disclosure" of conflicts by the adviser and informed consent by the client. The disclosure must 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." While inherently context-dependent, at a minimum the disclosure must describe the conflict and put the client on notice of its existence and import. For example, for an inter-client conflict, explain the impact of the conflict on each client and how the adviser intends to manage the conflicts.

An adviser must also obtain clients' "informed consent." The interpretation clarifies that informed consent "does not require advisers to make an affirmative determination that a particular client understood the disclosure and that the client's consent to the conflict of interest was informed." Rather, the adviser must provide "full and fair disclosure," in good faith, and in such a manner that the client should have been able to understand the conflict of interest and to provide informed consent to the conflict.

Notably, neither full and fair disclosure nor the required informed consent must be in writing—the manner of disclosure and consent can be facts and circumstances dependent. However, the consent must relate "either to a specific act or transaction, or acts or transactions . . . that could reasonably be expected to occur in the ordinary course of the relationship." Prior to accepting a client's consent, the adviser should probe whether it was truly informed and should not "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." While the federal fiduciary duty may not be waived, it only applies in a manner reflecting the agreed-upon scope of the relationship.

A New Enforcement Paradigm

Recent statements by Gensler highlight a renewed focus at the commission on conflicts and suggest a return to a period of heightened examinations and regulatory inquiries.

In the past, conflicts issues that the commission viewed as pervasive have often led to [focused SEC attention](#). In the late-1990s and early-2000s, conflicts among [research analysts](#) at investment banks became an SEC focus during examinations and spawned coordinated inquiries among regulators, leading to numerous notable [enforcement actions](#) and contributing to new statutory provisions under the [Sarbanes-Oxley Act of 2002](#), as well as further [regulatory restrictions](#) on research analysts.

Since 2021, Gensler has consistently emphasized advisers' obligations in connection with conflicts. For example, in a [November 2021 speech](#), Gensler reiterated that irrespective of attempts to modify an adviser's fiduciary duties under state law, the "federal fiduciary duty may not be waived." Echoing the interpretation, Gensler noted that "regardless of the sophistication of [a] client," advisers should "[m]ake no mistake: An Adviser to a private fund has a federal fiduciary duty to the fund enforceable [and not waivable] under the Advisers Act."

Additionally, in both his November speech and on [another occasion](#), Gensler intimated that existing rules do not go far enough in addressing advisers' conflicts, suggesting that new rules should be considered to both enhance disclosures and mitigate conflicts. The SEC has now proposed rules to address these issues. While the contours of the final rules are not yet clear, Gensler, has offered [his view](#) that regulation may also be appropriately effected by bringing enforcement actions in ". . . the hard cases, the novel cases, and yes, the high-impact cases . . ." Noting, "[s]ome market participants may call this 'regulation by enforcement.' I just call it 'enforcement.'"

New Rule Proposal Restricting Conflicts

The SEC's recent rule proposals represent an expansion of the federal fiduciary duty. Citing prior enforcement actions as evidence that certain conflicts of interest cannot be ameliorated through disclosure, the SEC proposed new [rules](#) that include restrictions and prohibitions relating to conflicts. Proposed Adviser Act rule 211(h)(2)-1 would prohibit charging certain fees and expenses to private funds or portfolio investments, regardless of disclosure. If adopted, this would prohibit accelerated monitoring fees, non-pro rata allocation of fees and expenses for portfolio investments, and shifting an advisers' regulatory or compliance fees to clients.

Notable SEC Enforcement Actions

While the SEC's enforcement agenda under Gensler is only beginning to take shape, advisers can look to recent Commission activity, and notable enforcement actions from prior administrations, for insight into how the SEC's approach to investigating and enforcing potential conflicts may unfold over the next few years. See, e.g., *SEC v. Cambridge Inv. Rsch. Advisors, Inc., et al.*, No. 22-cv-00071-SMR-SBJ (S.D. Iowa filed March 1, 2022); *In re City Nat'l Rochdale, LLC*, Administrative Proceeding File No. 3-20789 (Mar. 3, 2022).

Portfolio Companies

The relationship between an adviser and companies in which the adviser maintains significant positions has drawn particular SEC scrutiny. Depending on the structure, the adviser may be faced with challenging issues regarding the realization or allocation of certain performance gains, fee impositions, or other economic accruals. In situations where an adviser has multiple overlapping management relationships with both companies in which it is invested and an adviser's outside investors, full and fair disclosure of potential conflicts should be of paramount concern.

Similarly, multiple clients of an adviser may be invested in a particular company at different levels, posing unique challenges for conflict mitigation and disclosure. Alternatively, advisers could receive economic benefits from one company—such as referral fees, discounts, or ownership of a service provider or operating partner—that must be partially allocated to another company, fund, or group of investors.

Such interlocking relationships present complicated questions of whether to offset such allocations against fees owed to the adviser, how to inform clients who are unwilling or unable to receive material non-public information, or whether economic benefits may be realized by the investor at all. Additionally, acceleration provisions that trigger the payment of fees upon liquidation of a position may create conflicts between an adviser and investors who wish to maximize long-term value.

Allocation of Investment Opportunities

Advisers face significant challenges when attempting to fairly allocate investment opportunities, strategies, or personnel among competing funds, clients or projects. Conflicts can arise between the interests of an adviser and its clients, or between or among an adviser's clients. According to the interpretation, advisers should establish allocation methodologies that consider “the nature and objectives of the client and the scope of the relationship,” and allocate opportunities consistent with each client's best interests.

In *In re JH Partners, LLC*, an adviser and certain of its principals provided interim financing and working capital to a portfolio company but failed to disclose the conflicts posed by these investments. See *In re JH Partners, LLC*, Administrative Proceeding File No. 3-16968 (Nov. 23, 2015). The SEC found that the adviser violated its fiduciary duties because certain of the investments were senior to that of the adviser's clients and that JH Partners failed to disclose and obtain consent from the relevant fund's advisory board that a separate fund was investing in the same portfolio company but at different levels of the capital structure.

Expense Allocation/Fee Offsets

Ensuring that an adviser's clients are apprised of the material facts of relationships between an adviser and its operating partners or service providers and a portfolio company is critical. While axiomatic, advisers must also ensure that that expenses and fees are allocated among funds and/or offset against an adviser's management fee consistent with such disclosure.

In *In re Aisling Cap., LLC*, the SEC charged an adviser for failing to offset consulting fees it received from a portfolio company with management fees paid to the adviser by a fund. See *In re Aisling Cap. LLC*, Administrative Proceeding File No. 3-18564 (Jun. 29, 2018). Specifically, the adviser entered into agreements with two portfolio companies to provide consulting services. While the adviser disclosed the possibility of receiving consulting fee revenue from portfolio companies and had created a model to offset consulting fees against management and other fees paid to the adviser, negligence and control failures by the adviser prevented the offsets from being computed correctly.

Similarly, in *In re Lightyear Cap., LLC*, an adviser permitted its employees to invest in portfolio companies side-by-side with outside investors on a proportional basis. See *In re Lightyear Cap. LLC*, Administrative Proceeding File No. 3-18958 (Dec. 26, 2018). While the adviser disclosed that certain portfolio company expenses would be allocated to its funds, it failed to disclose that such expenses were not being allocated to the employee investments co-investment vehicle. Additionally, while the adviser disclosed that certain advisory fee payments from portfolio companies would offset management fees, certain offsets were allocated to co-investors that provided no services to the portfolio companies, reducing the offsets received by other investors.

Accelerated Monitoring Fees

Full and fair disclosure and informed client consent of accelerated monitoring fees—lump sum payments of fees that would have been incurred but for an exit prior to the full term of the management agreement—is a critical issue for advisers. Advisers expecting to seek accelerated monitoring fees should generally disclose the ability to collect monitoring fees, such that their clients can make informed decisions as to any conflicts prior to their commitment of capital.

Additionally, advisers should make specific and timely disclosures to the funds' investment advisory committee (that is, the limited partner committee empowered to evaluate conflicts) once the details of the fee acceleration are known. Advisers in some instances, however, have sought authority to seek accelerated fees after capital was committed, failed to adequately disclose the specifics of the acceleration until after fees were taken, or failed to adequately detail the terms of the conflict.

Policies & Procedures & Compliance Issues

Conflicts of interest issues can also spawn scrutiny into other aspects of advisers' business or into compliance issues. Recently the SEC's Division of Examinations staff issued a [Risk Alert](#), highlighting their examination observations of advisers failing to act according to the conflicts of interest practices in their disclosures. While such statements put advisers' on notice of SEC staff scrutiny of conflicts of interest policies and practices, importantly, that scrutiny can also lead to further investigations and enforcement actions, including penalties or fines levied for other violations.

For example, in *In re Glob. Infrastructure Mgmt.*, the SEC charged an adviser with, among other things, failing to properly offset certain advisory and management fees, as set forth in the firm's offering and governing documents, and failing to adequately maintain reasonable policies and procedures. See *In re Glob. Infrastructure Mgmt., LLC*, Administrative Proceeding File No. 3-20683 (Dec. 20, 2021). While this settlement may have principally resulted from a failure to properly follow a firm's procedures, it demonstrates that investigations can often lead to additional allegations of collateral violations or compliance program failures.

Similarly, in *In re Alumni Ventures Grp., LLC and Michael Collins*, the SEC alleged that an adviser, in addition to making misleading disclosures to investors, engaged in transactions between its funds in violation of operating agreements. See *In re Alumni Ventures Grp., LLC and Michael Collins*, Administrative Proceeding File No. 3-20791 (Mar. 4, 2022). According to the SEC, Alumni Ventures Group represented that it charged an "industry standard '2 and 20'" fee without disclosing that management fees earned over the life of the fund would be paid immediately upon an investor's capital contribution.

Additionally, Alumni Ventures Group's operating agreements maintained that its funds would not commingle assets. However, unbeknownst to investors, Alumni Ventures Group allegedly repeatedly transferred assets through a series of inter-fund loans and transfers, without documentation of repayment terms or maturity, and which were then repaid solely at Alumni Ventures Group's discretion. In addition to violating the funds' operating agreements, the SEC alleged that the transactions constituted undisclosed conflicts between Alumni Ventures Group and its funds, as the adviser bore sole responsibility for determining the repayment timing and terms of the transactions.

Enforcement Outlook

Gensler's statements make clear that he supports commission staff bringing hard or novel cases that set regulatory expectations through enforcement actions. His statements, and recent commission actions, also demonstrate that the SEC takes an expansive view of advisers' federal fiduciary duty, beyond what was articulated in the interpretation.

Moreover, the proposed rules demonstrate the SEC's view that current industry practices have failed to adequately mitigate certain types of conflicts of interest, suggesting that the SEC likely intends to address their concerns through enforcement. As such, advisers should not assume that their current practices are sufficient to satisfy the SEC's examination or enforcement staffs, even if such practices are long-standing, widespread, or subject to a pending rule proposal.

Instead, advisers should carefully consider the obligations the SEC currently ascribes them under the Adviser's Act and through the federal fiduciary duty, past enforcement actions, recent signaling, and rule proposals for guidance in assessing their conflicts of interest and allocation policies and procedures, including fee and expense sharing arrangements and, fee acceleration practices and provisions.

Finally, advisers should remain cognizant that while their existing conflict disclosures may have been sufficient in the past, the SEC under Gensler appears intent on using the commission's enforcement authority to ensure the industry conforms its behavior to his view regarding potential and actual conflicts.