Private Funds Regulatory Update

August 2019

Contents:

SEC Releases Final Interpretation of the Standard of Conduct for Investment Advisers

The U.S. Securities and Exchange Commission has, for some time, been reviewing the standard of conduct required of investment advisers and broker-dealers under the federal securities laws. On June 5, 2019, these various initiatives concluded with the publication of four final items of guidance:

- *Commission Interpretation Regarding the Standard of Conduct for Investment Advisers* ("Fiduciary Interpretation");
- *Form CRS Relationship Summary; Amendments to Form ADV* ("Form CRS Release");

- *Regulation Best Interest*; and
- *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser* ("Solely Incidental Interpretation")

Fiduciary Interpretation

The Fiduciary Interpretation is the most important of the four items for private fund advisers. In the proposing release, the SEC indicated that it was considering certain positions that would treat advisory clients and investors the same, regardless of their sophistication. For example, the SEC proposal stated that "disclosure of a conflict alone is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act," and consent would not be effective where "the material facts concerning the conflict could not be fully and fairly disclosed."

The final Fiduciary Interpretation, however, hewed more closely to existing interpretations of fiduciary obligations under the Advisers Act.

1. *Federal Fiduciary Duty*. The SEC's view, citing U.S. Supreme Court decisions (and its own precedent), is that the Investment Advisers Act unambiguously establishes a federal fiduciary duty for investment advisers. Part of the goal of the Fiduciary Interpretation was to emphasize the SEC's position that this fiduciary duty exists, that it exists for all categories of clients and that it cannot be categorically waived.

2. *Conflicts of Interest Waivers*. The Fiduciary Interpretation did acknowledge and respond to industry concerns that the SEC would adopt the views from the proposal (i) that there are "circumstances in which disclosure alone cannot cure a conflict of interest" and (ii) that "an adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure of all material conflicts of interest."

   With respect to the efficacy of disclosure in curing conflicts of interest, the SEC clarified in the Final Interpretation that "[w]e believe that while full and fair disclosure of all material facts relating to the advisory relationship or of conflicts of interest and a client's informed consent prevent the presence of those material facts or conflicts themselves from violating the adviser's fiduciary duty, such disclosure and consent do not themselves satisfy the adviser's duty to act in the client's best interest."

   In addition, rather than adopting the proposal's language that would require advisers to "seek to avoid" and "disclose" conflicts of interest, the Fiduciary Interpretation set forth a position requiring an adviser to "eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict."

   The importance of this sentence should not be overlooked. In the Fiduciary Interpretation, the SEC has (i) acknowledged that advisers are not required to "seek to avoid" all conflicts of interests;

rather, an adviser may utilize disclosure in lieu of eliminating a conflict; and (ii) validated an "informed consent" concept for conflict of interest disclosures by an adviser.

3. *Contractual Limits*. The Fiduciary Interpretation expressly acknowledged that retail and institutional investors are differently positioned in their ability to assess conflicts, stating that "institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications."[1] However, the SEC made clear that this "greater capacity and more resources" point only goes so far, noting that "while the application of the investment adviser's fiduciary duty will vary with the scope of the relationship, the relationship in all cases remains that of a fiduciary to the client." The Fiduciary Interpretation specifically noted that overbroad waivers, such as the following, will not be permitted:
    - A contractual provision purporting to waive the adviser's federal fiduciary duty generally;
    - A statement that the adviser will not act as a fiduciary;
    - A blanket waiver of all conflicts of interest; or
    - A waiver of a specific obligation under the Investment Advisers Act.
4. *Guidance on the Duty of Care.* In the Fiduciary Interpretation, the SEC stated that an advisers fiduciary duties encompass a duty of care as well as a duty of loyalty. The Fiduciary Interpretation contains a number of indications as to what the "duty of care" is under the Investment Advisers Act. As set forth in the Fiduciary Interpretation, these obligations run to suitability (and a duty of inquiry to support a reasonable belief that advice is in the best interests of a given client), an obligation to seek best execution and a requirement to monitor performance over the course of a relationship.
5. *Use of Contingent Language in Disclosures.* The Fiduciary Interpretation specifically addressed the use of contingent disclosures, stressing that an adviser may not state that it "may" have a conflict when (i) the adviser, in fact, generally has the conflict or (ii) has such a conflict with respect to some, but not all, of the adviser's clients. Importantly, the SEC clarified that the use of "may" in disclosures of potential conflicts is appropriate when a conflict does not currently exist, but might reasonably present itself in the future.
6. *Specific Guidance on Allocation Policies.* The SEC specifically addressed investment allocation policies, which have been a keen focus in many examinations. In response to concerns from commenters that the SEC proposal could be viewed as requiring advisers to adopt rigid pro rata allocation policies, language in the Fiduciary Interpretation stressed that "when allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship. An adviser need not have pro rata allocation policies, or any

[1] *Commission Interpretation Regarding the Standard of Conduct for Investment Advisers*, Investment Advisers Act Release No. 5248, at 25-26 (June 5, 2019).

particular method of allocation, but, as with other conflicts and material facts, the adviser's allocation practices must not prevent it from providing advice that is in the best interest of its clients."

The Fiduciary Duty Interpretation is the SEC's first holistic statement regarding an investment adviser's federal fiduciary duties. It provides clarifications and precedent that we expect will be relied upon by both investment advisers and the SEC going forward. It also highlights the fact that the actual effectiveness of any given disclosure will remain to be determined in a "facts and circumstances" review.

Form CRS Release

The Form CRS Release requires registered investment advisers that provide advisory services to "retail investor" clients to complete, file and deliver new Part 3 of Form ADV, also known as a Form CRS Relationship Summary. The Form CRS Release confirmed that "[i]f a firm does not have retail investor clients … and is not required to deliver a relationship summary to any clients … , the firm will not be required to prepare or file a relationship summary." As the D.C. Circuit held in *Goldstein v. SEC*,[2] in the private fund context, the private fund itself is an adviser's client and, absent a separate relationship, investors in such private fund are not advisory clients.

For those advisers with separately managed accounts, it is important to note that "retail investor" is defined as "a natural person, or the legal representative of such natural person, who seeks or receives services primarily for personal, family or household purposes," which the SEC interprets broadly as any services provided to a natural person for his or her own account.[3] In other words, wealthy and sophisticated individuals are still "retail investors" who must receive the new mandated disclosure in Form CRS.

Firms that are required to complete Part 3 of Form ADV must file their initial relationship summary with the SEC between May 1, 2020 and June 30, 2020.

Regulation Best Interest and the "Solely Incidental" Interpretation

Regulation Best Interest and the Solely Incidental Interpretation apply only to broker-dealers and not to investment advisers.

Regulation Best Interest establishes a heightened standard of conduct for broker-dealers and their associated persons. Specifically, the heightened standard of conduct requires broker-dealers to (i) act in the best interest of retail customers when recommending a securities transaction or an investment program involving securities and (ii) establish policies and procedures reasonably designed to identify and disclose conflicts of interest and, when necessary, mitigate or, in certain circumstances, eliminate such conflicts.

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[2] 451 F.3d 873 (D.C. Cir. 2006).

[3] 17 CFR 275.204-5(d)(2).

The Solely Incidental Interpretation provides that investment advice is "solely incidental" to broker-dealer activity (and therefore a broker-dealer is not classified as an investment adviser under the Advisers Act) when it "is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[4] The Solely Incidental Interpretation reinforces that giving advice as to the value and characteristics of securities should not be the primary business of a firm relying on the broker-dealer exclusion from the definition of investment adviser under the Advisers Act, and it also provided guidance regarding the application of the "solely incidental" prong in the context of:

- Exercising investment discretion over customer accounts, stating that "there are situations where a broker-dealer may exercise temporary or limited discretion in a way that is not indicative of a relationship that is primarily advisory in nature," but "unlimited discretion would not be solely incidental to the business of a broker-dealer;" and
- Account monitoring, providing that the SEC "disagree[s] with commenters who suggested that *any* monitoring of customer accounts would not be consistent with the solely incidental prong."

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[4] *Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser*, Investment Advisers Act Release No. 5249, at 12 (June 5, 2019).

New Fund-of-Funds Rule for Registered Funds Under SEC Consideration

The SEC is currently considering a rulemaking proposal ("Proposed Fund-of-Funds Rule"), first proposed in December 2018, designed to streamline and enhance the regulatory framework for registered funds-of-funds under the Investment Company Act of 1940 ("Investment Company Act"). The Proposed Fund-of-Funds Rule would permit registered investment companies ("RICs") and business development companies ("BDCs") to invest in other RICs and BDCs beyond the limits currently permitted by section 12(d)(1) of the Investment Company Act without obtaining an exemptive order from the SEC. In order to rely on the Proposed Fund-of-Funds Rule, a fund would need to comply with certain conditions, including certain restrictions on a fund's ability to:

1. Control other funds;
2. Redeem shares of a fund beyond certain limits within 30 days;
3. Charge multiple layers of fees; and
4. Create overly complex fund structures.

If adopted in its current form, the Proposed Fund-of-Funds Rule would be unavailable to unregistered funds, such as private funds and foreign investment companies, however numerous comment letters were submitted in favor of permitting private funds to rely on the Fund-of-Funds Rule. Private fund managers may wish to monitor the ultimate outcome of the Proposed Fund-of-Funds Rule, in particular, if they wish to offer registered products or engage in substantial investments in RICs or BDCs.

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OCIE Focusing on Safeguarding of Customer Information and Books and Records Retention

The SEC's Office of Compliance Inspections and Examinations ("OCIE") has recently issued risk alerts relating to the safeguarding of customer information and books and records retention obligations. OCIE has issued three risk alerts relating to (i) the Safeguards Rule of Regulation S-P, (ii) the security risks associated with cloud storage providers and (iii) books and records retention obligations related to the use of electronic messaging. In addition, the SEC's staff ("Staff") has recently sent inquiries to many advisers requesting information on their use of cloud storage providers.[5]

1. *Risk Alert on Safeguards Rule of Regulation S-P.* In a Risk Alert issued on April 16, 2019, OCIE identified common deficiencies under Regulation S-P,[6] including advisers failing to implement policies and procedures reasonably designed to comply with Regulation S-P, as well as deficiencies in implementation, such as a lack of relevant training and monitoring, unsecure networks, and unimplemented or insufficiently tailored policies governing the use of personal electronic devices and outside data vendors. To the extent that investor records and information are maintained in databases administered by cloud storage providers, the requirements of the Safeguard Rule could apply to the use of such vendors.

2. *Risk Alert on Security of Cloud Storage Providers.* On May 23, 2019, OCIE published an additional Risk Alert focusing on the security risks associated with storage of customer data by investment advisers, including through cloud-based solutions. OCIE highlighted potential deficiencies that implicate data protection and oversight issues under Regulations S-P and S-ID (Identity Theft Red Flags rule), including:

    - Misconfigured network storage solutions (which are incapable of ensuring only authorized access) and the lack of policies addressing the security configuration of network storage;
    - Inadequate oversight of vendor-provided network storage solutions, such as through a failure to adopt policies, procedures, contractual provisions, or otherwise, that ensure the security settings on vendor-provided network storage solutions were configured in accordance with the firm's standards;
    - Insufficient data classification policies and procedures, such as through a failure to identify the types of data stored by a firm and appropriate controls for each type of data.

    In the Risk Alert, OCIE noted a configuration management program that includes policies and procedures governing data classification, vendor oversight and security features will help to

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[5] Advisers commonly utilize cloud storage providers for books and records retention, and the staff of the SEC's Division of Investment Management first addressed the use of such services in the *Omgeo LLC* no-action letter (August 14, 2009), stating that it would not recommend enforcement against an adviser utilizing cloud storage providers for records retention, provided that the adviser can access those records from its principal place of business.

[6] The Safeguards Rule of Regulation S-P (which is itself the main SEC rule governing privacy notices and procedures for investment advisers) requires every investment adviser registered with the SEC to adopt written policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information. 17 C.F.R. § 248.30(a) (2004).

mitigate the risks incurred when implementing on-premises or cloud-based network storage solutions. OCIE identified several features of effective configuration management programs, data classification procedures and vendor management programs, based on examination findings.

- Policies and procedures designed to support the initial installation, on-going maintenance, and regular review of network storage solutions;
- Guidelines for security controls and baseline security configuration standards to ensure that each network solution is configured properly; and
- Vendor management policies and procedures that include, among other things, regular implementation of software patches and hardware updates followed by reviews to ensure that those patches and updates did not unintentionally change, weaken, or otherwise modify the security configuration.

3. *Risk Alert on Retention of Electronic Messaging Records*. OCIE's focus on the use of cloud storage providers is another instance of its recent focus on records retention. OCIE raised similar issues in a December 2018 Risk Alert addressing the use of electronic messaging for business practices, where it identified practices that could be helpful to advisers in complying with related books and records retention obligations. The practices identified in this Risk Alert were based on the Staff's observations from a recent examination sweep focused on the use of text/SMS messaging, instant messaging, personal email and personal or private messaging ("Electronic Messaging") by advisers and their personnel to conduct business-related communications. OCIE's sweep specifically excluded the use of firm email accounts.

   In the Risk Alert, OCIE identified four recommended policies or procedures that advisers should adopt to enhance oversight and review of employee activity in the use of Electronic Messaging:

   - For advisers who allow the use of social media, personal email or personal websites, engaging third-party vendors to monitor the use of those platforms, archive their use for compliance with the SEC's Books and Record Rule and review content for key words and phrases to identify changes in content or flag other issues;
   - Reviewing social media sites on a regular basis to determine whether advisory personnel are using social media to conduct firm business, particularly to detect circumvention of complete or partial prohibitions on the use of social media for business purposes;
   - Conducting regular searches, or setting up automated alerts of advisory personnel on various websites to determine whether unauthorized firm business is being conducted online; and
   - Arranging an anonymous or confidential system through which employees can report any Electronic Messaging, social media posting or website communications which may be considered conducting firm business through an unapproved platform.

OCIE further identified certain cybersecurity practices which may enhance advisers' insight into and control over advisory personnel use of Electronic Messaging for business purposes, including (i) requiring employees to obtain pre-approval for the use of firm applications, including Electronic Messaging apps, on personal devices; (ii) loading security software on firm-issued or personal devices that roll out cybersecurity updates, monitor for prohibited applications and delete locally stored information from devices that have been reported as lost or stolen; and (iii) only allowing access to advisers' email servers through VPN, or other similar secure connection.

In light of OCIE's recent risk alerts and inquires, advisers should review their practices, policies and procedures with respect to the storage of electronic customer information, the use of cloud storage providers and the retention of records created by the use of Electronic Messaging. Advisers should consider whether their policies and procedures address the areas identified by the Staff with respect to recordkeeping, training, due diligence and cybersecurity.

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National Futures Association Adopts Interpretive Notices Regarding Internal Controls and Cybersecurity

Effective April 1, 2019, the National Futures Association ("NFA") recently adopted two interpretive notices that, respectively, impose additional obligations regarding formal supervision of key financial functions ("The Internal Controls Notice"),[7] and expand and clarify past guidance on addressing cybersecurity risks ("The Cybersecurity Amendments").[8] Both affect all private fund managers that are NFA members, and require the attention of senior administrative personnel.

1. *The Internal Controls Notice.* NFA Compliance Rule 2-9 imposes a general requirement for NFA members to "diligently supervise" their personnel. The Internal Controls Notice is intended to supplement Rule 2-9 and provide CPOs with guidance on the design of an adequate financial controls system as well as to set forth certain "minimum components" of such a system. The Notice emphasizes the importance of a strong internal controls environment, including the active participation of senior management in establishing the integrity of the internal controls system and separation of duties (i.e., no single employee should be in a position to both carry out and conceal errors or fraud or have control over any two phases of a transaction or operation covered by the NFA's interpretive notice). Prescribed controls measures for key risk areas, such as investment activity, financial transactions and use of administrators, are also identified. For instance, controls should include verification of proper account custody, periodic reconciliation of ledgers, step-by-step confirmation of the redemption process and verified compliance with Rule 2-45; third-party administrators should be subject to appropriate diligence (including auditors' reports) to confirm performance and capability. In terms of the specificity of its requirements, the Internal Controls Notice breaks new ground for the NFA.

2. *The Cybersecurity Amendments*. The NFA's 2016 cybersecurity interpretive notice prescribed that members create a written framework of supervisory practices to address unauthorized access risks and established general requirements relating to such programs. Building upon this guidance, The Cybersecurity Amendments clarify who has authority to approve an information systems security program or "ISSP," strengthen employee information security training requirements (which must now occur at least annually after training at hiring), mandate familiarity with other applicable data privacy regulatory regimes, and, perhaps most notably, create a new, "narrowly drawn," cybersecurity breach notification requirement for NFA members triggered by loss of member, customer or counterparty funds, or notice being delivered to customers or counterparties under state or federal law.

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[7] *See* NFA Interpretive Notice I-19-03, *NFA adopts Interpretive Notice entitled NFA Compliance Rule 2-9: CPO Internal Controls System* (Jan. 31, 2019), available here.

[8] *See* NFA Interpretive Notice I-19-01, *NFA Amends Interpretive Notice Regarding Information Systems Security Programs—Cybersecurity* (Jan. 7, 2019), available here.

Contacts:

Brian T. Daly
Partner
Regulatory & Compliance
+1 212.756.2758
brian.daly@srz.com

Marc E. Elovitz
Partner
Regulatory & Compliance
+1 212.756.2553
marc.elovitz@srz.com

Anna Maleva-Otto
Partner
Regulatory & Compliance
+44 (0) 20 7081 8037
anna.maleva-otto@srz.com

Brad L. Caswell
Special Counsel
Regulatory & Compliance
+1 212.756.2072
brad.caswell@srz.com

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com