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## **SEC Proposes Rules and Interpretations Regarding Duties of Investment Advisers and Broker-Dealers**

***OCIE Issues Risk Alert on Frequent Advisory Fee and Expense Compliance Issues***

***BEA Form BE-12 Due May 31, 2018***

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### **SEC Proposes Rules and Interpretations Regarding Duties of Investment Advisers and Broker-Dealers**

On April 18, 2018, the Securities and Exchange Commission (SEC) proposed for public comment several new rules and interpretations designed to protect retail investors in their relationships with registered investment advisers and broker-dealers. While not the primary focus of these proposals, private fund managers may be subject to new responsibilities if some of these rules and interpretations are adopted.

#### **Proposed SEC Interpretation Regarding Standard of Conduct for Investment Advisers and Request for Comment on Enhancing Investment Adviser Regulation**

Most relevant for private fund managers is the SEC's proposed interpretation, which consolidates in one place its views on the fiduciary duty investment advisers owe to their clients, and a request for comment on potential rules to enhance adviser regulation and protection of investors.<sup>i</sup> The U.S. Supreme Court has found that the Investment Advisers Act of 1940 (Advisers Act) imposes a fiduciary obligation on an investment adviser, and therefore the adviser must always act in the best interest of its clients.<sup>ii</sup> As a fiduciary, an adviser owes its clients a duty of care and a duty of loyalty, which duties are enforceable pursuant to the anti-fraud provisions of the Advisers Act, primarily Section 206 and the rules thereunder.

In its proposed interpretation, the SEC stated that the duty of care includes, among other things, the duty to: (i) act and to provide advice that is in the best interest of the client, (ii) seek best execution of a client's transactions and (iii) provide advice and monitoring over the course of the relationship. The SEC also provided guidance regarding an investment adviser's obligations in connection with its duty of care, including, among other things, the duty to: (i) make a reasonable inquiry into a client's financial situation, level of financial sophistication, investment experience and investment objectives (collectively, a client's investment profile), (ii) provide personalized advice that is suitable for and in the best interest of the client based on the client's investment profile, (iii) update a client's investment profile in order to adjust its advice to reflect any changed circumstances and (iv) take into account the costs of an investment strategy, including the cost of fees or compensation, when considering whether such investment strategy is in the best interest of the client.

The SEC stated that the duty of loyalty requires an investment adviser to: (i) put its client's interests first, (ii) not favor its own interests over those of a client or unfairly favor one client over another, (iii) make full and fair disclosure to its clients of all material facts relating to the advisory relationship and (iv) seek to avoid conflicts of interest with its clients and make full and fair disclosure of all material conflicts of interest that could affect the advisory relationship. The proposed guidance emphasized that with respect to conflicts of interest, disclosure must be sufficiently specific and clear so that a client has sufficient facts to provide informed consent to a conflicted transaction or arrangement.

The SEC is seeking public comment on whether: (i) its interpretation of an adviser's fiduciary duty offers sufficient guidance, (ii) there are any significant issues related to an adviser's fiduciary duty that the proposed interpretation has not addressed and (iii) it would be beneficial for the SEC to codify any portion of the proposed interpretation.

In addition, the SEC requested comment on whether certain requirements currently imposed on broker-dealers should be made applicable to investment advisers (including private fund managers), including: (i) requiring certain employees of an adviser to be subject to federal licensing and continuing education requirements, (ii) requiring delivery of periodic account statements to retail clients that specify the dollar amounts of fees and expenses charged by the adviser and others and (iii) net capital or other financial responsibility rules (including audit requirements and/or fidelity bonds) to ensure an adviser has the resources to compensate clients for losses resulting from, e.g., bankruptcy or fraud.

### **Proposed Form CRS Relationship Summary and Related Disclosure Requirements**

In an attempt to reduce what the SEC sees as confusion among retail investors regarding the nature of their relationships with registered investment advisers<sup>iii</sup> and broker-dealers, the SEC proposed a new disclosure document for those firms (Form CRS Relationship Summary).<sup>iv</sup> This short (four-page maximum) summary would inform retail investors about the relationships and services the investment adviser or broker-dealer offers, the standard of conduct and the fees and costs associated with those services, specified conflicts of interest, and whether the firm and its financial professionals currently have reportable legal or disciplinary events. Retail investors would receive a relationship summary at the beginning of a relationship with a firm, and would receive updated information following a material change. The relationship summary would be in addition to the existing obligation to deliver a Form ADV Part 2A brochure and would be subject to SEC filing and recordkeeping requirements.<sup>v</sup>

Of note to private fund sponsors, the relationship summary must only be delivered to a "retail investor," which is defined as a prospective or existing client or customer who is a natural person (and includes a trust or other similar entity that represents natural persons, even if another person is a trustee or managing agent of the trust). While this definition does not include an exemption based on net worth or investor sophistication, it does not seem to cover investors in private funds (who are not "clients" under the Advisers Act). Therefore, it appears that a private fund sponsor would not be required to comply with the proposed Form CRS requirement with respect to natural person limited partners in its funds.

### **Proposed Regulation Best Interest**

After many years of study and internal debate, the SEC proposed Regulation Best Interest, which establishes a standard of conduct for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer.<sup>vi</sup> Under the proposal, a broker-dealer must act in the best interest of the retail customer at the time a recommendation is made without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer. The SEC stated that this obligation would be satisfied if the broker-dealer: (i) before or at the time of such recommendation, reasonably discloses to the retail customer, in writing, the material facts relating to the scope and terms of the relationship, and all material conflicts of interest associated with the

recommendation, (ii) exercises reasonable diligence, care, skill, and prudence, (iii) establishes, maintains, and enforces written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all material conflicts of interest that are associated with such recommendation and (iv) establishes, maintains, and enforces written policies and procedures reasonably designed to identify and disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

Unlike the Department of Labor's "fiduciary rule" (which applied only in connection with providing investment advice under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986, and which was recently vacated by the United States Court of Appeals for the Fifth Circuit), Regulation Best Interest would apply to all relevant transactions between a broker-dealer and a "retail customer." A retail customer is defined in the proposal as a person, or the legal representative of such person, who: (i) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (ii) uses the recommendation primarily for personal, family, or household purposes. Based on this proposed definition, the sale of private fund interests by placement agents and other registered broker-dealers to institutional investors (such as corporations and pension plans) generally would not be covered by Regulation Best Interest. However, sales to high net worth individuals and their estate planning and related vehicles generally would be covered.

These three proposals have already drawn strong reactions from industry participants, and we will monitor developments as the rulemaking process progresses.

### **OCIE Issues Risk Alert on Frequent Advisory Fee and Expense Compliance Issues**

The SEC's Office of Compliance Inspections and Examinations (OCIE) recently issued a risk alert setting forth a list of compliance topics pertaining to advisory fees and expenses that OCIE has most frequently identified in exams of SEC-registered investment advisers.<sup>vii</sup> The risk alert re-affirms the importance of clear and fulsome disclosures surrounding fee and expense practices in materials provided by private fund managers to investors. OCIE noted that where an adviser fails to adhere to the terms of agreements or disclosed policies in respect of such fees and expenses, the adviser might be in violation of the anti-fraud and other provisions of the Advisers Act. OCIE also reminded advisers that they are required to adopt and implement written policies and procedures reasonably designed to prevent such violations.

OCIE highlighted the following common deficiencies in respect of advisory fees and expenses:

- **Fee-Billing Based on Incorrect Account Valuations:** valuing assets in a client's account using a different metric or process than that which was specified in fund documents or Form ADV.
- **Billing Fees in Advance or with Improper Frequency:** billing advisory fees at intervals different from those specified in fund documents or Form ADV or failing to reimburse a client a pro-rated portion of advisory fees where such client terminates advisory services mid-billing cycle.
- **Applying Incorrect Fee Rate:** applying a rate higher than that which was agreed upon in fund documents (including side letters).
- **Omitting Rebates and Applying Discounts Incorrectly:** failing to apply certain discounts, offsets or rebates to advisory fees as specified in fund documents (including side letters), including neglecting to reduce an investor's fee rate when the value of such investor's account reached a level commensurate with discounted fee rates under fund documents.
- **Disclosure Issues Involving Advisory Fees:** providing disclosures regarding advisory fees in regulatory filings (such as Form ADV) that are inconsistent with the actual practices of the adviser and failing to disclose certain other fees or markups in addition to advisory fees.

- Adviser Expense Misallocations: misallocating expenses to clients that ought to be borne by the adviser in contravention of disclosures in fund documents or Form ADV (e.g., expenses in connection with distribution and marketing of a fund, regulatory filing fees and travel).

In light of this risk alert and the SEC's ongoing focus on fee and expense issues, private fund sponsors should continue to review their disclosure in fund documents, side letters, regulatory filings and other communications with investors to ensure fee and expense practices are consistent with such documents.

### **BEA Form BE-12 Due May 31, 2018**

As discussed in our February 2018 Weil Private Equity Alert "[Regulatory Developments and Annual Compliance Obligations Applicable to Private Fund Sponsors](#)", the Bureau of Economic Analysis (BEA) five-year benchmark survey on Form BE-12 regarding foreign direct investment in the United States is due May 31, 2018.

The survey is required for U.S. entities in which a foreign person holds, directly or indirectly, 10% or more of its voting securities at any time during 2017. A U.S. entity that has such foreign ownership must complete the survey whether or not it is contacted by the BEA. If a non-U.S. fund owns 10% or more of the voting securities of a U.S.-domiciled portfolio company, the portfolio company generally would have to file. The BE-12 should be submitted on a consolidated basis, meaning all U.S. entities sharing common ownership that are required to file should complete one survey.

## ENDNOTES

- i The proposed interpretation and request for comment can be found [here](#).
- ii See, e.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
- iii Exempt reporting advisers would not be subject to the Form CRS requirement.
- iv The SEC release regarding the Form CRS Relationship Summary and related matters can be found [here](#).
- v The SEC also proposed new rules that would: (i) restrict broker-dealers, when communicating with a retail investor, from using the term “adviser” or “advisor” in specified circumstances and (ii) require broker-dealers and investment advisers to disclose, in retail investor communications, the firm’s registration status with the SEC and an associated natural person’s and/or supervised person’s relationship with the firm.
- vi The SEC release regarding Regulation Best Interest can be found [here](#).
- vii The risk alert can be found [here](#).

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