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OCIE'S Latest Risk Alert: Another Warning Shot for Private Fund Advisers

INTRODUCTION

On June 23, 2020, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert, Observations from Examinations of Investment Advisers Managing Private Funds (the "Risk Alert"), detailing their observed compliance issues—or "deficiencies"—from their examinations of registered investment advisers managing private equity funds or hedge funds ("private fund advisers"). The Risk Alert discussed the three main categories of deficiencies identified by OCIE: 1) conflicts of interest; 2) fees and expenses; and, 3) policies and procedures relating to material non-public information ("MNPI"). Under each category, OCIE discussed myriad deficiencies in granular detail, making this Risk Alert a particularly useful resource for advisers seeking detailed guidance to incorporate into their compliance programs.[1]

Through the Presence Exam Initiative started in October 2012, the OCIE staff sought to obtain a deepened understanding of the private equity industry. Two years later, they believed they had achieved that expertise. In the well-known "Sunshine Speech" from 2014, then-Director of OCIE Andrew Bowden made clear that the SEC viewed the private equity business model as different from other adviser models and that these differences created temptations, risks, and conflicts that were "real and significant."[2] As industry participants and observers know well, since that time the SEC has focused—through both examinations and enforcement actions—on how private fund advisers have handled these issues.

In June 2015, the SEC charged a private equity firm with misallocating more than $17 million in broken deal or diligence expenses related to unsuccessful transactions. In rapid succession, the SEC then brought subsequent actions against private fund advisers for: failing to disclose loans from clients; using funds to pay their operating expenses without authorization and disclosure; and failing to disclose fees and discounts from service providers. Amidst these actions, then-Chair Mary Jo White gave a speech to the Managed Fund Association in which she warned

industry participants to heed the lessons from these actions.[3] In the intervening years, the SEC has continued to bring a number of cases against private fund advisers.[4]

As certain of these same pitfalls are surfacing in this Risk Alert five years later (and in very recent enforcement actions, as discussed in the Conclusion), it is evident that these issues continue to pose challenges for the private fund industry. Fortunately, this Risk Alert can afford advisers another opportunity to enhance their compliance programs prior to their next examination.

CONFLICTS OF INTEREST

Conflicts of interest have been a particular area of focus for the SEC, and that focus has extended to private funds. Back in 2015, in a speech called "Conflicts, Conflicts Everywhere," then Co-Chief of the Asset Management Unit of the SEC's Division of Enforcement Julie Riewe observed that, "over and over again," the AMU witnessed advisers "failing properly to identify and then address their conflicts."[5] In light of the findings described in this Risk Alert, the SEC staff appears to have concluded that these words may still ring true today.

Indeed, in the Risk Alert, OCIE observed a range of conflicts of interest that it said appeared to implicate Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"), the anti-fraud provisions of the Act, or Advisers Act Rule 206(4)-8. Section 206 prohibits misstatements or misleading omissions of material facts and other fraudulent acts and practices in connection with investment advisory activities. Rule 206(4)-8 prohibits making false or misleading statements to, or otherwise defrauding, investors or prospective investors in pooled investment vehicles.

The deficiencies described by OCIE tended to be disclosure failures, and included:

- *Allocation of investments.* Private fund advisers did not adequately disclose how they allocated investments among their clients, including inadequate disclosure regarding preferential allocations of investment opportunities, or allocations of securities to certain clients at preferential prices.
- *Multiple clients investing in the same portfolio company.* Private fund advisers did not adequately disclose conflicts stemming from clients investing at different levels of the capital structure of the same portfolio company.
- *Financial relationships between investors or clients and the adviser.* Private fund advisers failed to disclose adequately economic relationships they maintained with certain of their investors (including "seed investors"), depriving other investors of sufficient information to assess potential conflicts.
- *Preferential liquidity rights.* Side letters and other agreements with certain investors providing for special terms, including preferential liquidity terms, were not always adequately disclosed.
- *Interests in recommended investments.* In some instances, private fund advisers failed to disclose their preexisting ownership or other financial interests in recommended investments.
- *Coinvestments.* Private fund advisers failed to disclose investments made by coinvestment vehicles and other coinvestors, or failed to follow in practice the disclosed process.
- *Service providers.* Private fund advisers failed to disclose conflicts posed by agreements with service providers under the control of the adviser, its affiliates, or family members of principals or with service providers who provided incentives to the adviser. In addition, advisers failed to follow procedures and/or maintain substantiating documentation regarding the arm's length nature of these agreements.
- *Fund restructurings.* When restructurings occurred, certain private fund advisers failed to disclose adequately certain significant information, including the value of the fund interests, investor options during restructuring, or economic benefits received by the adviser.

- *Cross-transactions.* With respect to buying and selling between clients (so-called "cross-transactions), private fund advisers failed to disclose adequately conflicts, including, for example, their pricing methodology, especially when such pricing was to the disadvantage of one client versus the other.

FEES AND EXPENSES

OCIE also observed a number deficiencies relating to fees and expenses that it said appeared to implicate Section 206 or Rule 206(4)-8, including:

- *Allocation issues*. Specifically, private fund advisers: allocated shared expenses in a manner that was inconsistent with their disclosures; charged clients for expenses that were not permitted by operating agreements; failed to comply with contractual limits on expenses charged; and, failed to follow travel and entertainment expense policies.
- *Operating partners.* Private fund advisers failed to disclose adequately the role and compensation of certain non-employees providing services to the funds.
- *Valuation.* Private fund advisers did not always value their client assets in accordance with their prescribed valuation processes or client disclosures, sometimes resulting in the overcharge of management fees and carried interest.
- *Fees and fee offsets.* Private fund advisers failed to maintain adequate procedures and properly handle fees received from portfolio companies, such as monitoring, board, and deal fees, by failing to calculate the fee offset consistent with disclosures; failing to provide the fee offset; improperly allocating fees among clients; or accelerating the portfolio company's monitoring fees without adequate disclosure. In some instances, these failures led to investors overpaying management fees.

POLICIES AND PROCEDURES RELATING TO MNPI

Finally, OCIE observed deficiencies under Section 204A of the Advisers Act and Advisers Act Rule 204A-1 ("Code of Ethics Rule"). Section 204A requires advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI. Rule 204A-1 requires advisers to adopt and maintain a code of ethics articulating standards of conduct for their personnel and addressing conflicts that arise from personal-account trading.

Deficiencies relating to Section 204A included, among other things, maintaining policies that failed to address risks stemming from interactions with insiders at public companies, expert network firms, and/or investors with information about investments (so-called "value added investors"). Of note, even where private fund advisers did maintain polices addressing these risks, OCIE still observed deficiencies in the funds' failure to enforce them.

Deficiencies under the Code of Ethics Rule included private fund advisers' failures to: enforce bans on trading in "restricted list" securities; enforce controls around the receipt of third-party gifts and entertainment; and, require access persons to submit certain transaction and holdings reports.

CONCLUSION

The Risk Alert is the product of OCIE's hundreds of examinations of private fund advisers each year. The appearance of conflicts of interest, fees and expenses, and policies and procedures relating to MNPI in the Risk Alert therefore suggests that, at least in the SEC staff's view, a significant percentage of private fund advisers continue to have room for improvement with respect to these perennial issues.

Indeed, certain of the issues highlighted in the Risk Alert have been the subject of very recent SEC enforcement actions against private fund advisers.

Nearly one month before the Risk Alert was issued, the SEC brought a settled administrative proceeding against a private equity firm and registered investment adviser finding that it failed to implement adequate policies and procedures to guard against the potential misuse of MNPI learned by a constituency director.[6] This fact pattern is closely related to a deficiency emphasized in the MNPI section of the Risk Alert.

And, two months before the Risk Alert, the SEC brought a settled proceeding against a private equity fund adviser for failing to fully disclose or obtain consent to its practice of charging private fund portfolio companies for the costs of certain services.[7] This case similarly fits squarely within one of the deficiencies identified by OCIE in the Risk Alert, in the area of fees and expenses.

As evidenced by the Risk Alert and related enforcement actions, the SEC clearly remains focused on conflicts of interest, fees and expenses, and policies and procedures relating to MNPI. Private fund advisers should view the Risk Alert as a warning shot, and use it as a resource in fortifying their compliance programs in these areas prior to the next wave of examinations, or they could risk an Enforcement referral.

[1] In its granularity, this Risk Alert is akin to OCIE's cybersecurity-related risk alerts which private fund advisers and others have relied on to improve their compliance programs. *See, e.g.*, SEC Office of Compliance Inspections and Examinations Publishes Observations on Cybersecurity and Resiliency Practices, SEC (Jan. 27, 2020), *available at* https://www.sec.gov/news/press-release/2020-20.
[2] Andrew J. Bowden, Spreading Sunshine in Private Equity (May 6, 2014) *available at* https://www.sec.gov/news/speech/2014--spch05062014ab.html.
[3] Mary Jo White, Keynote Address at the Managed Fund Association: "Five Years On: Regulation of Private Fund Advisers After Dodd-Frank" (Oct. 16, 2015), *available at* https://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html.
[4] *See, e.g., In the Matter of Lightyear Capital LLC*, Release No. IA-5096 (Dec. 26, 2018), *available at* https://www.sec.gov/litigation/admin/2018/ia-5096.pdf (settled proceeding against private equity fund manager for failure to allocate expenses to employee funds and co-investors investing alongside the flagship funds); *In the Matter of Visium Asset Management, LP*, Release No. IA-4909 (May 8, 2018), *available at* https://www.sec.gov/litigation/admin/2018/33-10494.pdf (settled proceeding against private fund manager for failing to enforce its MNPI-related policies after certain of its portfolio managers traded on MNPI received from outside consultants).
[5] Julie M. Riewe, Remarks to the IA Watch 17th Annual IA Compliance Conference: "Conflicts, Conflicts Everywhere" (Feb. 26, 2015), *available at* sec.gov/news/speech/conflicts-everywhere-full-360-view.html.
[6] *In the Matter of Ares Management LLC*, Release No. IA-5510 (May 26, 2020), *available at* https://www.sec.gov/litigation/admin/2020/ia-5510.pdf.
[7] *In the Matter of Monomoy Capital Management, L.P.*, Release No. IA-5485 (Apr. 22, 2020), *available at* https://www.sec.gov/litigation/admin/2020/ia-5485.pdf.