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SEC Risk Alert Shines Spotlight on Private Funds

On June 23, the U.S. Securities and Exchange Commission (SEC) Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert focused on compliance issues observed during its examinations of hedge fund and private equity fund managers. The Risk Alert noted that more than 36 percent of all SEC-registered investment advisers manage at least one private fund. This is a clear signal that the OCIE spotlight will be shining brightly on the activities of fund managers in 2021. The guidance in the Risk Alert does not chart any new compliance territory; many of these themes can be traced back to previous staff positions and prior SEC enforcement actions. However, this is the first time that an OCIE Risk Alert has been devoted solely to fund managers, making it a valuable tool for fund managers to use in reviewing and implementing their policies and procedures. The Risk Alert identified the following three key areas where OCIE staff commonly saw deficiencies in examinations of private fund advisers: (i) conflicts of interest, (ii) fees and expenses, and (iii) policies and procedures to prevent the misuse of material nonpublic information (MNPI).

Conflicts of Interest

OCIE staff found that private fund advisers failed to provide adequate disclosure with respect to, or were otherwise deficient in their handling of, the following conflicts of interest:

- *Allocations of investments*. OCIE staff observed conflicts relating to allocations of investments among clients, including the adviser's largest private fund clients, co-investment vehicles and separately managed accounts. For instance, some private fund advisers preferentially allocated limited investment opportunities to new clients, higher fee-paying clients, or proprietary accounts or proprietary-controlled clients, or allocated securities at different prices or in inequitable amounts among clients without adequate disclosure about the allocation process or in a manner inconsistent with the adviser's stated allocation process.
- *Multiple clients investing in the same portfolio company*. Private fund advisers did not provide adequate disclosure about conflicts created by causing clients to invest at different levels of a capital structure of an issuer.
- *Financial relationships between investors or clients and the adviser*. Private fund advisers failed to provide adequate disclosure about economic relationships between themselves and certain investors or clients.
- *Preferential liquidity rights*. OCIE staff noted that private fund advisers did not provide adequate disclosures about (i) preferential liquidity terms in side letters with certain investors or (ii) undisclosed side-by-side vehicles or separately managed accounts that invested alongside the flagship fund but had preferential liquidity terms. Failure to disclose these special terms meant that some investors were unaware of the potential harm that could be caused by selected investors redeeming their investments ahead of other investors.
- *Private fund adviser interests in recommended investments*. OCIE staff noted that private fund advisers who had interests in investments recommended to clients did not provide adequate disclosure of such conflicts.

- *Co-investments*. OCIE staff noted that private fund advisers did not adequately disclose conflicts related to investments made by co-investment vehicles and other co-investors, including by failing to follow a disclosed process for allocating co-investment opportunities, or by failing to provide adequate disclosure about arrangements with certain investors to other investors.
- *Service providers*. Advisers who had incentives to use certain service providers failed to disclose the incentives and related conflicts to investors adequately. In addition, OCIE staff noted that certain private fund advisers did not have in place procedures to ensure that they acted in accordance with their disclosures related to use of affiliated service providers.
- *Fund restructurings*. OCIE staff noted that private fund advisers had inadequately disclosed conflicts related to fund restructurings and "stapled secondary transactions." For instance, advisers purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the value of fund interests and did not provide adequate disclosure about investor options.
- *Cross-transactions*. OCIE staff noted that advisers inadequately disclosed conflicts related to purchases and sales between clients (cross-transactions).

Fees and Expenses

OCIE staff noted the following common issues with how private advisers disclose and allocate fees and expenses, which often leads to certain investors being overcharged:

- *Inaccurate allocation of fees and expenses*. In particular, (i) certain shared expenses (*e.g.*, broken-deal, due diligence, annual meeting, consultant and insurance costs) were allocated in a manner inconsistent with disclosures to investors or policies and procedures, (ii) expenses were charged to clients in a manner not permitted by the relevant fund operative agreements (*e.g.*, salaries of adviser personnel and compliance expenses), (iii) advisers failed to comply with contractual limits on expenses (*e.g.*, placement agent fees), and (iv) advisers failed to comply with internal travel and entertainment expense policies.
- *Operating partners*. Private fund advisers failed to provide adequate disclosures about the role and compensation of operating partners—individuals who may provide services to the private fund or portfolio companies but are not adviser employees—potentially misleading investors about who bears costs associated with such operating partners' services or causing investors to overpay.
- *Valuation*. OCIE staff noted that private fund advisers did not value client assets in accordance with their valuation processes or disclosures to clients, which potentially led to an overcharge of management fees and carried interest based on overvalued holdings.
- *Portfolio company fees*. OCIE staff noted the following inconsistencies in receipt of portfolio company fees (*e.g.*, monitoring fees, board fees or deal fees), which led to an overpayment of management fees: (i) failure to apply or calculate management fee offsets in accordance with disclosures; and (ii) disclosure of management fee offsets, but without adequate policies and procedures to track receipt of portfolio company fees, including compensation that operating professionals may have received from portfolio companies.

MNPI/Code of Ethics

OCIE noted several deficiencies in private funds' compliance with Section 204A of the Investment Advisers Act of 1940, as amended, and Rule 204A-1 (commonly known as the code of ethics rule). In particular, OCIE staff found that private fund advisers violated Section 204A or Rule 204A-1 by failing to address risks posed by:

- employees interacting with those who could have inside information in order to assess whether any MNPI could have been exchanged;
- employees who could obtain MNPI through access to office space or systems of the adviser or its affiliates; and
- employees who periodically had access to MNPI about issuers of public securities, which could potentially lead to misuses of MNPI by the adviser or any of its associated persons.[1]

In addition, OCIE staff noticed deficiencies in private funds' establishment, maintenance and enforcement of provisions in their codes of ethics reasonably designed to prevent misuse of MNPI. In particular, advisers failed to enforce their own policies regarding trading restrictions in respect of securities placed on the "restricted list," receipt of gifts and entertainment from third parties, and securities holdings and transaction reporting requirements applicable to access persons. The prevalence of the issues noted in the Risk Alert emphasizes the need for private fund managers to take a close look at how they collect MNPI, how they document the receipt of MNPI, and how their policies and procedures ensure that MNPI is not mishandled, internally or externally.

Takeaways

The SEC's compliance approach follows a well-established pattern: *first*, the SEC identifies compliance issues and publishes its priorities; *second*, the SEC issues a Risk Alert to the industry; and *third*, the SEC focuses on these identified issues during examinations and issues deficiency letters and pursues enforcement actions against advisers who have failed to heed the warnings. Now is the time for private fund advisers to revisit their written policies and procedures, using the Risk Alert as a checklist. Disclosure issues continue to persist because of the complexity inherent in identifying when certain activities may constitute a conflict of interest. Monitoring potential conflicts requires vigilance on a day-to-day basis. Even those fund managers that have modified their disclosures to comport with the Risk Alert need to continually monitor their operations to ensure that they are complying with their disclosed procedures regarding conflicts, calculation of fees and handling of MNPI. To that end, advisers should regularly compare/contrast their policies to their firm's actual day-to-day practice, provide compliance training to their employees, and issue reminders to employees to reinforce compliance with existing policies and procedures. Should you have any questions concerning this Risk Alert or investment adviser compliance in general, please contact any of the authors of this advisory or any members of the Day Pitney Investment Management and Private Funds group.

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[1] *See* Investment Advisers Act of 1940 Release No. 5510, dated May 26, in which the SEC found that Ares Management LLC, a registered investment adviser (Ares), obtained potential MNPI about a portfolio company through an Ares senior employee who sat on the company's board; Ares later purchased a large portion of the company's stock. The SEC's order in this case cited Ares' failure to implement its policies and procedures to prevent the use of MNPI.

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