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Insights: Alerts

OCIE's Focus on Private Fund Advisers Continues in Recent Risk Alert

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While the financial industry was busy enjoying family vacations and a relaxing break for the July 4th holiday, the SEC stayed busy releasing new guidance for industry participants. For example, OCIE[1] recently released a risk alert (the "Alert") warning SEC-registered investment advisers ("RIAs") who manage hedge funds or private equity funds ("Private Fund Advisers") of various deficiencies that OCIE has repeatedly identified in recent examinations. [2] The Alert follows on the heels of several recent SEC enforcement actions against Private Fund Advisers and targets many of the same issues that we identified in a recent legal alert, *Recent Enforcement Action Provides Helpful Guidance in Several Areas for Advisers to Private Funds*.[3] Further, many of the issues identified in the Alert are applicable not only to Private Fund Advisers, but also to RIAs who only provide services to registered investment funds and/or separately managed accounts. Specifically, the Alert highlights deficiencies involving: (1) insufficient disclosure of specific conflicts of interest, (2) violations relating to charging and/or disclosing fees and expenses, and (3) policies and procedures relating to the treatment of material non-public information ("MNPI").

1. Conflicts of Interest Disclosures

In the Alert, OCIE pointed to the antifraud provisions of the Investment Advisers Act of 1940 (the "Advisers Act"), [4] and reminded Private Fund Advisers of their obligation to make full and fair disclosure of all conflicts of interest that could incentivize them (even unconsciously) to render disinterested advice to clients.[5] OCIE found that Private Fund Advisers had inadequately disclosed the following types of conflicts to clients (i.e., clients of the Private Fund Advisers who are pooled investment funds, separately managed accounts, or otherwise) and/or investors (i.e., investors in the private investment fund clients of Private Fund Advisers):

- **Allocations of investments among clients**, such as preferential allocations to certain clients (e.g., higher fee-paying clients), or allocations of securities at different prices or in inequitable amounts among clients, either contrary to provided disclosures or without any disclosure at all;
- **Multiple clients investing in the same portfolio company**, such as when a Private Fund Adviser causes clients to invest in different levels of a portfolio company's capital stack (e.g., one client invests in debt, and the other in equity);
- **Financial relationships between investors or clients and the adviser**, such as inadequately disclosing conflicts regarding the role of investors (i.e., persons who have invested in the Private Fund Adviser's private fund clients) as seed investors for private fund clients, or failing to disclose to investors conflicts related to a certain investor's economic interests in the Private Fund Adviser or the Private Fund Adviser's private fund clients;
- **Preferential liquidity rights**, such as inadequately disclosing terms of investor side letters, and inadequately disclosing preferential liquidity terms held by side-by-side vehicles or separately managed accounts investing

alongside flagship funds, thus leaving other investors unaware of preferential liquidity rights that could harm other investors if exercised (e.g., investors with side letters and/or side-by-side vehicles could redeem their investments ahead of other investors);

- **Private Fund Adviser interests and financial incentives in recommended investments**, including both ownership interests and financial interests (e.g., financial incentives such as referral fees) of the Private Fund Adviser itself and ownership interests and financial interests of the Private Fund Adviser's principals and employees;
- **Coinvestments**, such as failing to follow disclosed processes for allocating coinvestment opportunities among investors, or failing to disclose the existence of agreements that provide coinvestment opportunities to some, but not all, investors;
- **Service providers**, such as failing to disclose to investors that a service provider who is an affiliate of the Private Fund Adviser is engaged by a portfolio company, and failing to disclose a Private Fund Adviser's financial incentives to use certain service providers (e.g., incentive payments from discount programs);
- **Fund restructurings and stapled secondary transactions**, such as failing to disclose to investors sufficient information regarding the value of investors' fund interests when purchasing such investors' fund interests at a discount, or otherwise failing to describe to investors their available options in a fund restructuring, or requiring that investors agree to a "stapled secondary transaction" [6] or provide other economic benefits to the Private Fund Adviser without adequate disclosures; and
- **Cross-transactions**, such as establishing prices that benefit either the selling or purchasing account, but disadvantage the other account, without adequate disclosures.[7]

2. Fees and Expenses

OCIE also identified several issues related to fees and expenses, including the following:[8]

- **Inappropriate allocation of fees and expenses across client accounts** in a manner inconsistent with the Private Fund Adviser's policies and procedures, governing documents, or contractual limitations with clients;
- **Inadequate disclosures regarding "Operating Partners,"** such as failing to distinguish the role and compensation (and who bears the cost of such compensation) of individuals that are not employed by a Private Fund Adviser but provide services to the Private Fund Adviser's private fund clients or portfolio companies;
- **Incorrect valuation of client assets**, specifically in a manner that is not in accordance with the Private Fund Adviser's valuation processes or disclosures to clients;
- **Improper receipt of portfolio management fees from portfolio companies**, such as failing to calculate management fee offsets in accordance with disclosures made to clients, or disclosing management fee offsets but failing to implement policies and procedures to track the receipt of portfolio company fees.[9]

3. MNPI Policies and Procedures, Code of Ethics

Finally, OCIE found that Private Fund Advisers had failed to:

- **Address MNPI-related risks in policies and procedures**, specifically with respect to: (1) employee interactions with third parties (e.g., insiders of publicly-traded companies, outside consultants, and "value added investors"[10]) and failing to enforce policies and procedures related thereto; (2) employees who could

obtain MNPI through their ability to access office space and systems of the Private Fund Adviser or the Private Fund Adviser's affiliates that possess MNPI; and (3) employees with access to MNPI of issuers of public securities;[11] and

- **Implement and enforce MNPI-related requirements in the code of ethics**, including: (1) the enforcement of trading restrictions on securities that had been placed on the Private Fund Adviser's "restricted list," and the development of policies and procedures for creating such lists; (2) the enforcement of requirements regarding the receipt of gifts and entertainment from third parties; and (3) the enforcement of requirements to submit certain personal securities transactions for preclearance.[12]

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As in recent enforcement actions against Private Fund Advisers, a key focus of the Alert is a reminder of a Private Fund Adviser's duty to not only adopt policies and procedures, but also to implement and monitor those policies and procedures to ensure that they are working as intended. We encourage Private Fund Advisers to regularly review and test their compliance programs to ensure that their policies and procedures and disclosure documents do not need to be updated in light of any new activities or relationships, changes in regulatory expectations, or because prior processes are not operating as intended. These reviews and any changes made as a result of such reviews should be documented and such documentation should be maintained in the Private Fund Adviser's records.

In addition, Private Fund Advisers should review written policies and procedures for consistency with their disclosure documents, and to ensure that all such documents accurately reflect actual practices. In this regard, Private Fund Advisers should especially pay attention to their use of "may" in disclosure documents and policies and procedures. For example, in instances where a particular practice or transaction has actually occurred or is likely to occur, Private Fund Advisers should consider whether the practice or transaction already creates a conflict of interest that should be disclosed to investors and clients more specifically than merely stating that it may occur. Further, if disclosure is necessary, Private Fund Advisers should ensure that the disclosure is detailed and specific, and not so generalized that key features of the practice or transaction (e.g., the Private Fund Adviser's receipt of fees) cannot be easily understood by investors and clients.

Finally, we believe that the Alert provides valuable guidance to not only Private Fund Advisers, but to all RIAs generally. Many of the issues addressed in the Alert are applicable not only to Private Fund Advisers, but to other types of RIAs who may have similar disclosure issues (e.g., allocation of investments among clients, preferential rights given to some clients through agreements, relationships with service providers, valuation of client assets, and MNPI-related policies and procedures). Thus, RIAs that provide services to registered investment funds and separately managed accounts should also examine their policies and procedures and disclosure documents to ensure that they adequately address the deficiencies identified in the Alert and accurately reflect the RIAs' actual practices.

If you have any questions about the Alert or about the regulation of Private Fund Advisers or RIAs generally, please feel free to contact us.

*By the **Investment Management and Broker-Dealer Team** at **Kilpatrick Townsend & Stockton***

Footnotes

[1] The Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission.
[2] SEC Office of Compliance Inspections and Examinations Risk Alert, *Observations from Examinations of Investment Advisers Managing Private Funds* (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf (hereinafter, "Risk Alert").
[3] Jeffrey Skinner, Lauren Jackson, Lauren Henderson, and MacRae Robinson, Legal Alert, *Recent Enforcement Action Provides Helpful Guidance in Several Areas for Advisers to Private Funds* (June 5, 2020), available at https://www.kilpatricktownsend.com/Insights/Alert/2020/6/Recent-Enforcement-Action-Provides-Helpful-Guidance-in-Several-Areas-for-Advisers-to-Private-Funds.
[4] Specifically, OCIE pointed Private Fund Advisers to Section 206 of the Advisers Act, which "prohibits investment advisers from employing any device, scheme, or artifice to defraud any client or prospective client, and from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," as well as Rule 206(4)-8 under the Advisers Act, which "prohibits investment advisers to pooled investment vehicles from (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle." Risk Alert, supra note 1, at 1-2.
[5] *Id* at 1.
[6] A "stapled secondary transaction" is a transaction where a Private Fund Adviser combines the sale of a private fund portfolio with an agreement by the purchaser to commit capital to the Private Fund Adviser's future private fund. *Id*. at note 6.
[7] *Id*. at 1-4.
[8] OCIE noted that these deficiencies, like the conflicts of interest issues, appear to violate Section 206 and Rule 206(4)-8 under the Advisers Act. *Id*. at 4.
[9] *Id*. at 4-5.
[10] Examples of "value added investors" include corporate executives or financial professional investors that have information about investments. *Id*. at 6.
[11] OCIE noted that these deficiencies appear to violate Section 204A of the Advisers Act, which requires that RIAs "establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the adviser or any of its associated persons." *Id.*
[12] OCIE noted that these deficiencies appear to violate Rule 204A-1 under the Advisers Act, which requires RIAs "to adopt and maintain a code of ethics, which must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel." *Id.*

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