Harvard Law School Forum on Corporate Governance

SEC Identifies Private Fund Deficiencies

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Editor's note: Brian T. Daly and Marc E. Elovitz are partners at Schulte Roth & Zabel LLP. This post is based on their SRZ memorandum. Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst (discussed on the Forum here) and Insider Trading Via the Corporation by Jesse Fried (discussed on the Forum here).

On June 23, 2020, the SEC Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert[1] that highlights commonly encountered deficiencies in examinations of hedge fund managers and private equity fund sponsors.

At the outset, the Risk Alert connects its observations with respect to private investment funds with the current Commission's repeated focus on retail investors, noting that private funds "frequently have significant investments from pensions, charities, endowments and families." Indeed, the Risk Alert is described as not only useful information for advisers to private funds; it is offered "to provide investors with information concerning private fund adviser deficiencies."

While the Risk Alert does not establish new standards of conduct, it does provide a concise summary of three categories of deficiencies the examination staff stated that it finds in its reviews of advisers to private funds. These findings are consistent with what we have observed on examination of private fund advisers.

Every private fund manager should carefully evaluate whether its policies and procedures are consistent with the positions described in the Risk Alert. Compliance personnel should also integrate the various elements into the next annual compliance review and be prepared to discuss them with the examination staff in future examinations.

Categories of Deficiencies

While there is no single theme that unites all of the deficiencies highlighted in the Risk Alert, in general, they are matters that implicate the possibility of economic harm to clients (or a loss of economic benefits) or violations of the insider trading and other securities laws. These highlighted deficiencies fall into three general categories:

- Gaps in client and investor disclosures regarding conflicts of interest;
- Fees and expenses issues; and

[1] SEC's Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020), available here.

- Shortcomings in managers' policies and procedures regulating the treatment of material nonpublic information ("MNPI").

Conflicts of Interest Deficiencies

Conflicts of interest always present challenges for a fiduciary, as is the case in an advisory relationship. In the modern private fund environment, with many managers operating multiple funds and accounts for investors and clients with different economic terms, the existence of conflicts of interest is unavoidable. (The "conflicts" disclosures of fund offering documents, for example, can be quite lengthy.)

Under Section 206 of the Investment Advisers Act of 1940, as explained in the SEC's recent "fiduciary interpretation,"[2] investment advisers have an affirmative obligation either (i) to fully disclose; or (ii) to mitigate (or eliminate) conflicts of interest within an advisory context. In addition, SEC Rule 206(4)-8 prohibits an adviser from making material misstatements and omissions in communications to clients and from otherwise engaging in manipulative, deceptive or fraudulent business conduct; these anti-fraud measures also effectively require advisers to disclose material conflicts that could adversely affect clients.

In the Risk Alert, OCIE highlights a number of conflicts of interest that it believes were often inadequately disclosed by examinees.

- OCIE noted instances of inadequately disclosed conflicts concerning the allocation of investment opportunities among client vehicles and accounts, such as flagship funds, co-investment vehicles and SMAs. In addition to preferential allocations of limited investment opportunities to proprietary accounts or clients paying higher fees without adequate disclosure, OCIE identified preferential allocations of limited opportunities to "new accounts" without adequate disclosure. While "ramp up" periods for new accounts may be appropriate, OCIE may question whether a manager is seeking to show positive early performance returns to new clients and investors. OCIE also noted that some advisers fail to consistently apply their allocation policies.
- *Conflicting Client Investments.* With an increasing number of clients and strategies, managers may more frequently face conflicts between investment positions taken by different clients. The Risk Alert cites inadequate disclosures of the conflicts arising from different clients investing in different parts of a portfolio company's capital structure, such as debt versus equity. While the Risk Alert does not provide any indication of the type of disclosure language that would be satisfactory in these circumstances, they have squarely identified this as an issue requiring attention.
- *Financial Relationships.* The Risk Alert identifies inadequacies in the disclosure of economic relationships between a manager and certain clients or investors, such as seed investors, and investors that provided financing to the adviser or its funds.
- *Preferential Liquidity Rights.* The Risk Alert reports that some managers have entered into side letters including providing preferential liquidity, without adequately notifying other investors of the potential harm that could be caused. OCIE also identifies side-by-side vehicles or SMAs investing alongside a fund with more frequent liquidity as creating the same risk. The Risk Alert does not identify actual harm to investors in these

[2] SEC Release No. IA-5248, "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," available here.

circumstances, but emphasizes the importance of adequate disclosure to all investors, particularly in times of market dislocation.

- *Principal Investments.* OCIE's findings included failures to adequately describe the conflicts associated with principals or managers holding interests in investments recommended to clients.
- *Co-Investments.* The Risk Alert also evidenced concerns over the accuracy and depth of disclosures on how co-investment procedures actually operate, as well as situations where managers did not follow their stated policies. OCIE specifies two particular scenarios: (1) advisers disclosed an allocation policy covering multiple different clients but then failed to follow the process as disclosed; and (2) advisers failed to adequately disclose agreements to provide co-investment opportunities to certain investors, such that other investors may not have understood "the scale of co-investment opportunities and in what manner co-investment opportunities would be allocated among investors." Again, the degree of specificity in disclosure that would be satisfactory to the examination staff is not specified, but the focus on these disclosures is clear.
- *Service Providers.* Advisers sometimes failed to adequately disclose conflicts arising from the use of affiliated service providers or service providers with a special relationship to the adviser or its portfolio companies. The Risk Alert also identifies other financial incentives, such as payments from discount programs, that could influence advisers' choice of service providers for its clients and their portfolio companies. As a matter of process, advisers should seek to ensure that their practices with respect to affiliated service providers follow their disclosures. OCIE identified situations where advisers disclosed that services would be provided on terms no less favorable than from a third-party, but did not take appropriate steps to support such disclosures (e.g., obtaining quotes from comparable third-party service providers).
- *Fund Restructurings*. Consistent with recent focus on examinations, OCIE identified situations where advisers failed to provide sufficient disclosures concerning conflicts raised by fund restructurings and "stapled secondary transactions." Examples listed include inadequate disclosure by the adviser (1) regarding the valuation of the fund interest that the adviser is purchasing from investors; (2) of investor options during a restructuring; and (3) of the conflict of interest of the adviser about the economic benefits to the adviser.
- *Cross Transactions*. The Risk Alert notes inadequate disclosure with respect to the conflicts inherent in cross transactions, particularly where the adviser determines the price of the securities and where either the purchaser or seller is disadvantaged.

It is important to note, however, that these conflicts-related deficiencies all relate to insufficient disclosures (and—to be clear—do not assert that these conflicts were *per se* inconsistent with or were violative of an adviser's fiduciary duty). The staff's focus on disclosure is consistent with the Commission's 2019 fiduciary interpretation, and highlights how critical it is for advisers to both identify and sufficiently disclose conflicts.

Fees and Expenses Deficiencies

Fees and Expenses. Six years after OCIE identified what it viewed as widespread deficiencies in connection with private fund managers charging fees and expenses, the Risk Alert identifies recurring "fee and expense issues that appear to be deficiencies under Section 206 or Rule 206(4)-8". These items fall into two buckets:

- Impermissible expenses (e.g., expenses that violate a fund's organizational documents or fee calculation errors); and
- Expenses that were assessed on the basis of disclosures that OCIE deemed to be too general or imprecise to constitute informed consent by investors.

Many of the situations cited in the inadequate disclosure category were not only previously identified by OCIE, they have been the subject of enforcement actions settled over the past several years (e.g., pass-throughs of affiliated "operating partner" compensation, monitoring fees and "broken deal" expenses). Disclosures with respect to "operating partners" were identified as insufficient, both as to their roles and their compensation.

Fees from portfolio companies were also cited as problematic, including in circumstances where (1) management fees were not offset because the portfolio company paid fees to an affiliate of the adviser and not the adviser itself; (2) portfolio company fees were allocated to clients that paid no management fee; (3) advisers did not have adequate policies and procedures to track the receipt of portfolio company fees, including compensation to operating partners; and (4) monitoring fees were accelerated despite the lack of specific disclosure of that practice.

In addition to identifying specific issues with respect to fees and expenses, the Risk Alert notes deficiencies in advisers failing to comply with their stated policies. For example, the Risk Alert identifies advisers failing to comply with expense caps and failing to comply with their own travel and entertainment policies.

Valuation. The Risk Alert also highlights the way in which valuation can impact fees received by managers. While this is not a new area of concern for the SEC or for OCIE, the Risk Alert does make clear that valuation has been and will continue to be a key focus area in private fund examinations. The Risk Alert cites situations where advisers valued client assets in a manner that was inconsistent with their valuation procedures as well as valuation practices that were not consistent with the disclosures made to clients and investors.

MNPI and Code of Ethics Deficiencies

The third category of OCIE concerns related to Section 204A of the Advisers Act, which requires advisers to establish and maintain written policies and procedures to prevent misuse of MNPI, and the Code of Ethics Rule, Rule 204A-1, which obligates advisers to establish standards of conduct for advisory personnel and resolve conflicts raised by their personal trading.

Insider Trading. Despite the significant risks to advisers associated with insider trading, the examination staff identified what it viewed as insufficient policies and procedures to prevent the misuse of MNPI. The Risk Alert cites advisers as failing to address risks posed by employees interacting with people with access to MNPI, such as public company insiders, consultants retained through "expert networks" and "value-added investors."

Specific mention was made of advisers that had policies and procedures addressing such risks, but where enforcement was lacking. Two other specific issues were identified by OCIE with respect to insider trading polices: (1) the risk of employees obtaining MNPI through access to office space or systems of the adviser or its affiliates; and (2) the risk of employees with access to public company information such as PIPE transactions (private investment in public equities).

Code of Ethics Rule. The Risk Alert identifies three discrete issues with respect to advisers' Codes of Ethics and the prevention of the misuse of MNPI:

- *First*, certain advisers failed to establish policies and procedures around their restricted trading lists. The staff observed a lack of specificity with respect to the process for adding and removing securities from the restricted trading list. But they also identified failures to enforce trading restrictions of names that were on the list.
- *Second*, the staff observed deficient practices around enforcement of the gifts and entertainment sections of the Code of Ethics, specifically with respect to the receipt of gifts and entertainment from third parties.
- *Third*, deficiencies were identified with respect to personal securities transactions approval and reporting, including failing to require the timely submission of such approvals and reports. In addition, advisers did not identify all individuals who should be treated as "access persons" for purposes of the Code of Ethics.

These concerns have been reflected in numerous recent enforcement actions, where advisers have been fined and publicly sanctioned for shortfalls in the design or operation of their compliance programs. The inclusion of these items in the Risk Alert should act to dispel any notion that the staff is going to shift its focus away from critically assessing the compliance function.

Next Steps

The Risk Alert presents results from hundreds of examinations of private fund managers conducted by OCIE each year. Although it does not purport to address all types deficiencies noted in examinations of private fund managers, it covers a broad range of some of the most nuanced issues these managers face. In addition to its breadth, the Risk Alert drills down on certain issues, identifying the specific challenges private fund advisers face. The Risk Alert demonstrates the increased knowledge and understanding by the staff of private fund managers and the relevant legal and compliance challenges.

The Risk Alert should be carefully reviewed by all SEC-registered private fund advisers, and compliance personnel should consider making the review as interdisciplinary and robust as their situations permit. A critical review of the disclosures relating to conflicts of interests, expenses and other key points of potential friction within a fiduciary relationship should be undertaken. It appears that the majority of the deficiencies described in the Risk Alert could have been avoided with direct, specific and understandable disclosures of the conflicts and their impact. Consistent with the Commission's 2019 fiduciary interpretation, the more significant the conflict of interest, the higher the bar is for crafting effective conflicts disclosure.

A review of MNPI policies and practices also is warranted. In addition to the Risk Alert's warnings from OCIE, recent SEC enforcement actions have resulted in sanctions against private fund managers for failures to have adequate policies and processes in place, even where a substantive violation was not alleged. High-level policies that do not reflect operational realities or specific risks, compliance procedures that are not both tailored and detailed, and procedures (of whatever level of detail) that are not conscientiously enforced can result in a situation that will not meet the standards expected and identified by both the examination staff and the Enforcement Division of the SEC.