RISK ALERT
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

June 23, 2020

Observations from Examinations of Investment Advisers Managing Private Funds

I. Introduction

This Risk Alert provides an overview of certain compliance issues observed by the Office of Compliance Inspections and Examinations ("OCIE")* in examinations of registered investment advisers that manage private equity funds or hedge funds (collectively, "private fund advisers"). Over 36 percent of investment advisers registered with the Commission manage private funds, which frequently have significant investments from pensions, charities, endowments, and families. OCIE examines hundreds of private fund advisers each year and is frequently asked about its observations from these examinations as well as common deficiencies and compliance issues. Many of the deficiencies discussed below may have caused investors in private funds ("investors") to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund. This Risk Alert is intended to assist private fund advisers in reviewing and enhancing their compliance programs, and also to provide investors with information concerning private fund adviser deficiencies.[1]

II. Private Fund Adviser Deficiencies[2]

This Risk Alert discusses three general areas of deficiencies that OCIE has identified in examinations of private fund advisers: (A) conflicts of interest, (B) fees and expenses, and (C) policies and procedures relating to material non-public information ("MNPI").

A. Conflicts of Interest

Section 206 of the Investment Advisers Act of 1940 ("Advisers Act") 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. An investment adviser must eliminate or

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* The views expressed herein are those of the staff of OCIE. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by OCIE staff and is not legal advice.

1 Examinations of private fund advisers do not all result in OCIE issuing a deficiency letter. The Commission has brought Enforcement actions on a number of the issues discussed in this Risk Alert. OCIE continues to observe some of these practices during examinations.

2 This Risk Alert does not address all deficiencies among private fund advisers. OCIE published a risk alert on February 7, 2017, The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers, which identifies the most common deficiencies across all types of investment advisers.

make full and fair disclosure of all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which is not disinterested such that a client can provide informed consent to the conflict. In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent.[3]

In addition, Advisers Act Rule 206(4)-8 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.

OCIE staff has observed the following conflicts of interest that appear to be inadequately disclosed and deficiencies under Section 206 or Rule 206(4)-8:[4]

- *Conflicts related to allocations of investments.* The staff observed private fund advisers that did not provide adequate disclosure about conflicts relating to allocations of investments among clients, including the adviser's largest private fund clients ("flagship funds"), private funds that invest alongside flagship funds in the same investments ("coinvestment vehicles"), sub-advised mutual funds, collateralized loan obligation funds, and separately managed accounts ("SMAs") (together, "clients"). For example:

    - The staff observed private fund advisers that preferentially allocated limited investment opportunities to new clients, higher fee-paying clients, or proprietary accounts or proprietary-controlled clients, thereby depriving certain investors of limited investment opportunities without adequate disclosure.

    - The staff observed private fund advisers that allocated securities at different prices or in apparently inequitable amounts among clients (1) without providing adequate disclosure about the allocation process or (2) in a manner inconsistent with the allocation process disclosed to investors, thereby causing certain investors to pay more for investments or not to receive their equitable allocation of such investments.

- *Conflicts related to multiple clients investing in the same portfolio company.* The staff observed private fund advisers that did not provide adequate disclosure about conflicts created by causing clients to invest at different levels of a capital structure, such as one client owning debt and another client owning equity in a single portfolio company, thereby depriving investors of important information related to conflicts associated with their

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[3] The Advisers Act imposes a fiduciary duty on investment advisers, which includes both a duty of care and a duty of loyalty. The duty of loyalty requires that an adviser not subordinate its clients' interests to its own. In other words, an investment adviser must not place its own interest ahead of its client's interests. To meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (June 5, 2019).

[4] This Risk Alert uses phrases such as "adequate disclosure" or "adequate information" when referencing a private fund adviser's disclosure obligations.

investments.

- *Conflicts related to financial relationships between investors or clients and the adviser.* The staff observed private fund advisers that did not provide adequate disclosure about economic relationships between themselves and select investors or clients. In some cases, these investors acted as initial investors in the adviser's private funds (also known as "seed investors"). In other situations, these select investors - for example, having provided credit facilities or other financing to the adviser or the adviser's private fund clients - had economic interests in the adviser. Failure to provide adequate disclosure about these arrangements meant that other investors did not have important information related to conflicts associated with their investments.

- *Conflicts related to preferential liquidity rights.* The staff observed private fund advisers that entered into agreements with select investors ("side letters") that established special terms, including preferential liquidity terms, but did not provide adequate disclosure about these side letters. As a result, some investors were unaware of the potential harm that could be caused if the selected investors exercised the special terms granted by the side letters. Similarly, the staff observed private fund advisers that set up undisclosed side-by-side vehicles or SMAs that invested alongside the flagship fund, but had preferential liquidity terms. Failure to disclose these special terms adequately meant that some investors were unaware of the potential harm that could be caused by selected investors redeeming their investments ahead of other investors, particularly in times of market dislocation where there is a greater likelihood of a financial impact.

- *Conflicts related to private fund adviser interests in recommended investments.* The staff observed private fund advisers that had interests in investments recommended to clients, but did not provide adequate disclosure of such conflicts. In some instances, adviser principals and employees had undisclosed preexisting ownership interests or other financial interests, such as referral fees or stock options in the investments.

- *Conflicts related to coinvestments.* The staff observed inadequately disclosed conflicts related to investments made by coinvestment vehicles and other coinvestors, potentially misleading certain investors as to how these coinvestments operate. For example, the staff observed private fund advisers that disclosed a process for allocating coinvestment opportunities among select investors, or among coinvestment vehicles and flagship funds, but failed to follow the disclosed process. The staff also observed private fund advisers that had agreements with certain investors to provide coinvestment opportunities to those investors, but did not provide adequate disclosure about the arrangements to other investors. This lack of adequate disclosure may have caused investors to not understand the scale of coinvestments and in what manner coinvestment opportunities would be allocated among investors.

- *Conflicts related to service providers.* The staff observed inadequately disclosed conflicts related to service providers and private fund advisers. For example, portfolio companies controlled by advisers' private fund clients entered into service agreements with entities controlled by the adviser, its affiliates, or family members of principals without adequately disclosing the conflicts. The staff also observed advisers that had other financial incentives for portfolio companies to use certain service providers, such as incentive payments from discount programs, but failed to disclose the incentives and conflicts to investors adequately.

- The staff also observed private fund advisers that did not have in place procedures to ensure that they followed their disclosures related to affiliated service providers. Advisers represented to investors that services provided to the private funds or portfolio companies by affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated third parties. However, the advisers did not have procedures or support to establish whether comparable services could be obtained from an unaffiliated third party on better terms, including at a lower cost.

- *Conflicts related to fund restructurings.*[5] The staff observed private fund advisers that inadequately disclosed conflicts related to fund restructurings and "stapled secondary transactions."[6] For example:

  - Advisers purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the value of the fund interests. The staff also observed advisers that did not provide adequate disclosure about investor options during restructurings, potentially impacting the decisions made by investors.

  - Advisers did not provide adequate information in communications with investors about fund restructurings. The staff observed advisers that required any potential purchaser of investor interests to agree to a stapled secondary transaction or provide other economic benefits to the adviser without adequate disclosure about the conflict to investors.

- *Conflicts related to cross-transactions.* The staff observed private fund advisers that inadequately disclosed conflicts related to purchases and sales between clients, or cross-transactions. For example, advisers established the price at which securities would be transferred between client accounts in a way that disadvantaged either the selling or purchasing client but without providing adequate disclosure to its clients.

B. Fees and Expenses

OCIE staff observed the following fee and expense issues that appear to be deficiencies under Section 206 or Rule 206(4)-8:

- *Allocation of fees and expenses.* The staff observed private fund advisers that have inaccurately allocated fees and expenses. For example:

  - Advisers allocated shared expenses, such as broken-deal, due diligence, annual meeting, consultants, and insurance costs, among the adviser and its clients, including private fund clients, employee funds, and coinvestment vehicles, in a manner that was inconsistent with disclosures to investors or policies and procedures, thereby causing certain investors to overpay expenses.

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[5] Fund restructurings are transactions where a private fund adviser arranges the sale of an existing private fund or the fund's portfolio to a purchaser. In a restructuring, the purchaser often offers the existing investors the option to sell their interests or roll their interests into a new, restructured private fund.

[6] A "stapled secondary transaction" combines the purchase of a private fund portfolio with an agreement by the purchaser to commit capital to the adviser's future private fund.

- Advisers charged private fund clients for expenses that were not permitted by the relevant fund operating agreements, such as adviser-related expenses like salaries of adviser personnel, compliance, regulatory filings, and office expenses, thereby causing investors to overpay expenses.

- Advisers failed to comply with contractual limits on certain expenses that could be charged to investors, such as legal fees or placement agent fees, thereby causing investors to overpay expenses.

- Advisers failed to follow their own travel and entertainment expense policies, potentially resulting in investors overpaying for such expenses.

- *"Operating partners."* The staff observed private fund advisers that did not provide adequate disclosure regarding the role and compensation of individuals that may provide services to the private fund or portfolio companies, but are not adviser employees (known as "operating partners"), potentially misleading investors about who would bear the costs associated with these operating partners' services and potentially causing investors to overpay expenses.

- *Valuation.* The staff observed private fund advisers that did not value client assets in accordance with their valuation processes or in accordance with disclosures to clients (such as that the assets would be valued in accordance with GAAP). In some cases, the staff observed that this failure to value a private fund's holdings in accordance with the disclosed valuation process led to overcharging management fees and carried interest because such fees were based on inappropriately overvalued holdings.

- *Monitoring / board / deal fees and fee offsets.* The staff observed private fund advisers that had issues with respect to the receipt of fees from portfolio companies, such as monitoring fees, board fees, or deal fees (collectively "portfolio company fees"). For example:

  - Advisers failed to apply or calculate management fee offsets in accordance with disclosures and therefore caused investors to overpay management fees. In some instances, advisers incorrectly allocated portfolio company fees across fund clients, including private fund clients that paid no management fees. The staff also observed advisers that failed to offset portfolio company fees paid to an affiliate of the adviser that were required to be offset against management fees.

  - Advisers disclosed management fee offsets, but did not have adequate policies and procedures to track the receipt of portfolio company fees, including compensation that their operating professionals may have received from portfolio companies, potentially causing investors to overpay management fees.

  - Advisers negotiated long-term monitoring agreements with portfolio companies they controlled and then accelerated the related monitoring fees upon the sale of the portfolio company, without adequate disclosure of the arrangement to investors.

C. MNPI / Code of Ethics

Section 204A of the Advisers Act ("Section 204A") requires investment advisers to 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. Advisers Act Rule 204A-1 ("Code of Ethics Rule") requires a registered investment adviser 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.

OCIE staff observed the following issues that appear to be deficiencies under Section 204A or the Code of Ethics Rule:

- *Section 204A.* The staff observed private fund advisers that failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI as required by Section 204A. For example:

    - Advisers did not address risks posed by their employees interacting with: (1) insiders of publicly-traded companies, (2) outside consultants arranged by "expert network" firms, or (3) "value added investors" (*e.g.*, corporate executives or financial professional investors that have information about investments) in order to assess whether MNPI could have been exchanged. The staff also observed private fund advisers that did not enforce policies and procedures addressing these risks.

    - Advisers did not address risks posed by their employees who could obtain MNPI through their ability to access office space or systems of the adviser or its affiliates that possessed MNPI.

    - Advisers did not address risks posed by their employees who periodically had access to MNPI about issuers of public securities, for example, in connection with a private investment in public equity.

- *Code of Ethics Rule.* The staff observed private fund advisers that failed to establish, maintain, and enforce provisions in their code of ethics reasonably designed to prevent the misuse of MNPI. For example:

    - Advisers did not enforce trading restrictions on securities that had been placed on the adviser's "restricted list." The staff also observed advisers that had codes of ethics that provided for the use of restricted lists, but did not have defined policies and procedures for adding securities to, or removing securities from, such lists.

    - Advisers that failed to enforce requirements in their code of ethics relating to employees' receipt of gifts and entertainment from third parties.

    - Advisers that failed to require access persons to submit transactions and holdings reports timely or to submit certain personal securities transactions for preclearance as required by their policies or the Code of Ethics Rule, as applicable. The staff also observed advisers that failed to identify correctly certain individuals as "access persons" under their code of ethics for purposes of reviewing personal securities transactions.

III. Conclusion

OCIE examinations of private fund advisers have resulted in a range of actions, including no-comment letters, deficiency letters and, where appropriate, referrals to the Division of Enforcement. In response to these observations, many of the advisers modified their practices to address the issues identified by OCIE staff. OCIE encourages private fund advisers to review their practices, and written policies and procedures, including implementation of those policies and procedures, to address the issues discussed in this Risk Alert.

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.