



U. S. SECURITIES AND EXCHANGE COMMISSION

# ***Compliance Outreach Seminar New York Regional Office***

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***June 18, 2015***



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## *How the SEC supervises HF and PE*

**5 Members: Chairman + 4 Commissioners**

### **5 Divisions**

- Division of Corporation Finance
- Division of Trading and Markets
- Division of Investment Management
- Division of Enforcement
- Division of Economic and Risk Analysis (DERA)

### **Multiple Offices**

- Office of Compliance, Inspections and Examinations.
- Office of the Chief Accountant
- Office of the General Counsel
- Office of International Affairs
- Office of Investor Education and Advocacy

**HQ + 11 Regional Offices**



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## *How the SEC supervises HF and PE*

### Office of Compliance, Inspections & Examinations

- **Mission**: Improve compliance, prevent fraud, inform policy and monitor risk.
- 400 + examiners focused on asset management.
- Private Funds Unit.
- Private Fund Specialized Working Group

#### Investment Management

- Private Funds Branch.

#### Enforcement

- Asset Management Unit
  - ~75 Attorneys and Industry Specialists.



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## *How the SEC supervises HF and PE*

### Private Funds Unit

- **Leadership**: Igor Rozenblit
- **Location**: SEC Regions with high concentration of private fund advisers
- **Composition**: Highly experienced examiners and exam managers
- **Activities**: Conduct examinations of private fund advisers (improve compliance and prevent fraud), monitor risks, follow trends and build expertise.
  - **Private Fund Advisers**: Hedge Funds, Private Equity, Infrastructure, Real Estate Private Equity etc.
  - **Exams**: Risk priority, Presence, Cause, others



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## *Key Regulatory Documents (Public)*

<u>Form</u>	<u>Contents</u>	<u>Location / System</u>
ADV Part 1	Manager's demographic information.	<u>IAPD</u> : Investment Adviser Public Disclosure System (SEC Website)
ADV Part 2A	Disclosure of fees, manager compensation, disciplinary history, conflicts of interest and other key arrangements.	<u>IAPD</u> : Investment Adviser Public Disclosure System (SEC Website)
ADV Part 2B	Biographical information about Supervised Persons and long form discussion of topics contained in ADV 2A	Not filed with SEC but available by request from registrant.
Enforcement Action Notices	Releases are usually issued anytime there is a settlement, a filed case or a decision.	Internet/ SEC Website
S-1	IPO disclosures including information about monitoring agreement termination fees.	<u>EDGAR</u> (SEC Website)



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## *Key Regulatory Documents (Non-Public)*

### Form

Form PF

Staff Findings /  
Deficiency  
Letters

Subpoenas

### Contents

Demographic and some asset class level data designed to help federal regulators monitor systemic risk and help the SEC protect investors.

Final document produced by SEC Examiners memorializing findings identified during an exam.

Issued by the Division of Enforcement during an active investigation.





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# *Private Equity Issues*



## *Operational and Reputational Risks*

### **Fraud**

- Theft
- “Strategy Drift” -- Investment Misappropriation

### **Manager Impairment**

- Hidden Team Issues
- Regulatory Sanctions

### **Returns Impairment**

- Hidden Fees / Expense Shifting
- Favoritism / Deal Allocation



## *Operational Issues: Fraud*

### Issue:

**Theft**: Misappropriation of fund assets for personal gain. (Ex: Lawrence Penn / Camelot Management<sup>(1)</sup>)

### Possible Tests:

- Test robustness of cash management procedures
- Ensure complete audits by qualified auditors
- Identify related party service providers
- Verify assets (Challenge in control situations)
- Conduct background checks



## *Operational Issues: Fraud*

### Issue:

**Investment Misappropriation**: Misappropriation of fund assets into undisclosed investments. (Ex: Meditron Asset Management <sup>(1)</sup>)

### Possible Tests:

- Verify the existence of a robust Investment Committee process;
  - Request and review memoranda
- Request capital call notices, LPAC presentations, fund financial statements.
- Ensure manager has proper expertise to execute stated strategy.



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## *Operational Issues: Manager Impairment*

### Issue:

**Hidden Team Issues:** Undisclosed plan team departures which occur only after the closing of the fund.

### Possible Tests:

- Ensure robust key man provision.
- Directly question the intentions of each key team member.
- Be wary of situations with stated strategy changes



## *Operational Issues: Manager Impairment*

### Issue:

**Regulatory Sanctions:** Sanctions or investigations by SEC resulting in business distractions, reputational damage or industry bars.

### Possible Tests:

- Ensure Chief Compliance Officer is competent/autonomous and robust compliance program.
  - Size of compliance staff.
  - Integration of compliance staff into the business.
  - Compliance procedures covering high risk areas.
    - Valuation, co-investment, fee and expense disclosure, personal trading.



## *Operational Issues: Returns Impairment*

### Issue:

**Fee and Expense Issues**: Charging unexpected fees or allocating unexpected expenses to funds or portfolio companies.

### Possible Tests:

- Ensure sufficient fee and expense disclosure and compliance mechanism.
- Verify past practices, especially in large control deals.
  - Check S-1s for public firms.
- Focus on Operating Partner/Senior Advisors; relationships / agreements with portfolio companies.



## *Operational Issues: Returns Impairment*

### Issue:

**Favoritism / Deal Allocation:** Allocation of investments / co-investments / deal expenses to favored parties at the expense of investors.

### Possible Tests:

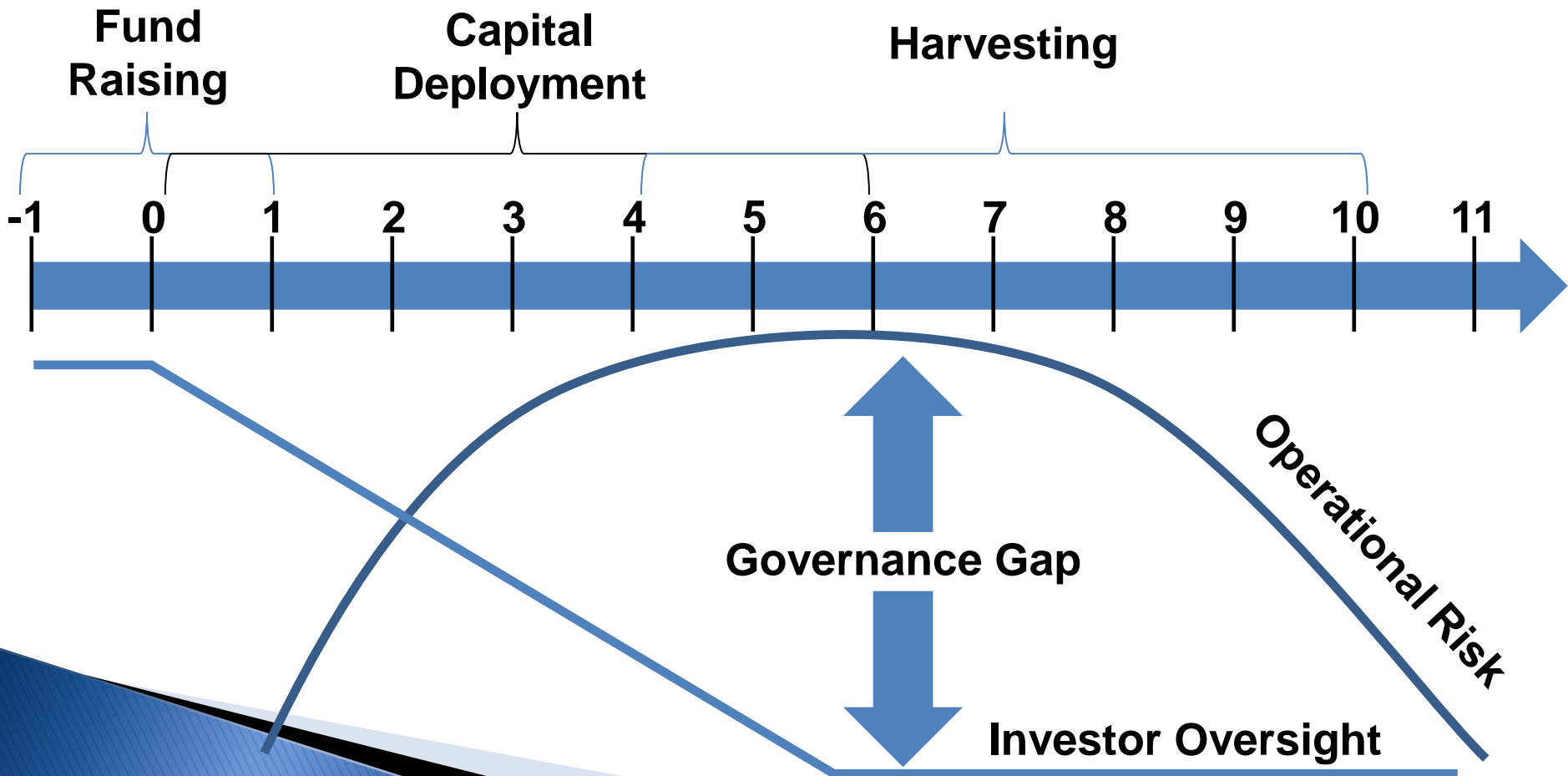
- Verify the existence of acceptable co-investment, deal allocation and deal expense allocation policies.
  - Validate the existence of a process to enforce the policies.
- Identify LP or related party mezzanine / debt providers.





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# *Continuous Operational Due Diligence*





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# *Private Equity Real Estate Issues*



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# *Operational Issues: Disclosure/Conflicts*

## INVESTMENT ADVISER/GP

- (1) Investment Management Services
- (2) Oversight of investments
- (3) Vertical integration

## PROPERTY MGR

- (1) Affiliate, JV Partner or National
- (2) Day-to-day responsibilities
- (3) Provides transparency (if affiliated)

## SERVICE PROVIDERS

- (1) Affiliate or 3<sup>rd</sup> Party
- (2) Construction, insurance, etc.
- (3) Provides transparency (if affiliated)



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## *Operational Issues: Disclosure/Conflicts*

### Issue:

**Fees/Expenses**: Charging unexpected fees and expenses at the property level

### Possible Considerations:

- Ensure adequate disclosure related to the use of affiliates
- Identify conflicts related to the use of affiliated service providers
- Review controls in place to monitor such arrangements, including service providers



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# *Hedge Fund Issues*



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## *Operational Issues: Disclosure*

**Issue:**

**Style Drift:** Policies and Procedures and marketing materials do not reflect the underlying business / portfolio

**Possible Considerations:**

- How has the business changed
- Review risks inherent in new strategies
- Identify conflicts with existing portfolios
- Do investor communications and marketing materials reflect underlying portfolios



## *Operational Issues: Conflicts*

### Issue:

**Allocations**: How are opportunities allocated across multiple portfolios

### Possible Considerations:

- How often is the allocation policy reviewed/set
- What are the economic consequences of the various fee structures
- How are potential conflicts communicated to investors



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## *Operational Issues: Disclosure*

### Issue:

**Disclosure:** Does underlying portfolio reflect the disclosure in offering docs

### Possible Considerations:

- Is portfolio risk consistent with offering materials and PPM regarding
  - Excessive Leverage
  - Over-concentration
  - Use of derivatives
  - Liquidity
  - Counterparties





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## *Questions?*

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