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# OCIE to Private Fund Advisers: How Many Times Do I Have to Tell You?

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On June 23, 2020, the Office of Compliance Inspections and Examinations (OCIE) of the U.S. Securities and Exchange Commission (SEC) published a Risk Alert (found here) specific to investment advisers managing private funds. As described below, the Risk Alert discusses three general areas of deficiencies found in recent examinations: (A) conflicts of interest, (B) fees and expenses and (C) policies and procedures relating to material non-public information (MNPI).

The Risk Alert addresses a number of themes that the SEC staff has previously addressed over the years,[1] which augurs heightened scrutiny on these themes in upcoming examinations. Given the granularity of guidance in the Risk Alert, private fund advisers should expect examinations to be focused on the specific themes referenced herein.

## Conflicts of Interest

In recent examinations, OCIE has observed inadequate disclosures and deficiencies pertaining to conflicts of interest on the following issues:

- *Allocations of Investments* — OCIE has observed that certain allocations to private fund adviser clients may not be equitable or in accordance with adviser disclosures and policies regarding how allocations are made. An adviser should pay assiduous detail to ensuring that an allocation policy exists, that it follows this policy, that the policy is properly disclosed to its investors and that the adviser documents how such allocation decisions are made.
- *Conflicting Investments in a Portfolio Company* — OCIE has observed insufficient disclosure surrounding conflicts resulting from multiple clients investing at different levels of a capital structure in the same portfolio company, such as one client owning debt and another client owning equity in the same company. This observation reminds advisers to be mindful of the resulting conflicts and potential misaligned incentives when a portfolio company undergoes a new round of investment a liquidity event or becomes insolvent.
- *Conflicted Financial Relationships between the Clients and the Adviser* – OCIE has observed insufficient disclosure surrounding beneficial treatment given to socalled "seed investors" that have provided credit facilities or other financing to a private fund or otherwise had economic interests in the adviser.
- *Preferential Liquidity Rights* — OCIE has observed insufficient disclosure with respect to preferential liquidity rights that benefit one investor to the potential detriment of other investors, a concern more prevalent to open ended vehicles such as hedge funds than closed ended vehicles.

[1] *See, e.g.*, Andrew J. Bowden, Director of OCIE, *Spreading Sunshine in Private Equity* (May 6, 2014); Julie M. Riewe, Co-Chief of Asset Management Division, *Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View* (Feb. 26, 2015); Marc Wyatt, Director of OCIE, *Private Equity: A Look Back and a Glimpse Ahead* (May 13, 2015); Andrew Ceresney, Director of Division of Enforcement, *Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement* (May 12, 2016); U.S. Securities Exchange Commission, Office of Compliance Inspections and Examinations, *2020 Examination Priorities* (Jan. 7, 2020).

- *Private Fund Adviser Interests in Recommended Investments* — OCIE has observed that certain private fund advisers had undisclosed financial interests in fund investments, such as referral fees or stock options.
- *Coinvestments* — OCIE has reiterated its concerns over inadequate disclosure surrounding coinvestments, including allocation of opportunities, preferential coinvestment agreements in side letters and the failure of advisers to follow documented coinvestment policies. This guidance should not surprise private fund advisers, but one new takeaway from the Risk Alert is that the disclosure should contemplate the potential scale of coinvestments.
- *Service Provider Relationships* – OCIE has found inadequate disclosure surrounding adviser affiliated service agreements with fund portfolio companies. Any financial incentives for portfolio companies to use certain adviser-affiliated service providers should be disclosed.
- *Fund Restructurings* – OCIE has found that certain advisers had purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the restructuring or the value of fund interests or the options available to investors during the restructurings. Specifically with respect to so-called "stapled secondary transactions," wherein a purchaser of a private fund portfolio also agrees to commit to an adviser's future private fund, OCIE has found that existing investors did not receive adequate disclosure about the conflicts of interest posed in such transactions.
- *Cross-transactions* – OCIE has repeated its concern surrounding inadequately disclosed conflicts, particularly with respect to pricing determinations, related to purchases and sales between clients.

## Fees and Expenses

OCIE observed the following deficiencies surrounding fees and expenses:

- *Allocation of Fees and Expenses* – OCIE has again reminded private fund advisers of the importance of fairly allocating shared expenses, such as expenses pertaining to broken-deal, due diligence, annual meeting, consultants and insurance costs, across private fund clients, employee funds and coinvestment vehicles in accordance with investor disclosures and documented policies and procedures. OCIE has observed problems with improperly assessing costs to private fund clients that should have been borne by the advisers, failure to comply with contractual limits on certain expenses that could be charged to investors, such as legal fees or placement agent fees, and failure to follow documented travel and entertainment expense policies.
- *"Operating Partners"* – OCIE has observed failures in providing adequate disclosure regarding the role and compensation of so-called "operating partners" (i.e., individuals who provide services to private funds or portfolio companies but are not adviser employees), potentially misleading investors about who would bear the costs associated with such persons' services. OCIE has not previously dedicated much attention to the roles and expenses of operating partners in examinations. Given the prevalence of operating partners especially in the private equity and venture capital industries, advisers should regard this Risk Alert as advance notice of heightened scrutiny on this subject.
- *Valuation* – OCIE has observed failures to value client assets in accordance with valuation processes or in accordance with disclosures (such as valuing in accordance with GAAP) that, in some cases resulted in higher management fees and carried interest being paid.
- *Monitoring Fees* – With respect to the receipt of fees from portfolio companies, such as monitoring fees, board fees or deal fees, OCIE has observed failures to apply appropriate management fee offsets in accordance with disclosures and failures to properly allocate the offsets across fund clients. OCIE also has observed inadequate policies and procedures to track the receipt of such fees. OCIE also has observed that certain long-term monitoring agreements with portfolio companies had contractual provisions for the acceleration of fees upon the sale of the portfolio company without adequate disclosure of the arrangement to investors.
- OCIE has addressed the issue of acceleration of monitoring fees before, and particularly in a prominent enforcement actions.[2] Private fund advisers should ensure that any monitoring fee arrangement, or potential entry

[2] *See, e.g.*, In re Blackstone Mgmt. Partners L.L.C., Investment Advisers Act Release No. 4219, (Oct. 7, 2015); In re Apollo Mgmt. V, L.P., Investment Advisers Act Release No. 4493 (Aug. 23, 2016); In re TPG Capital Advisors, LLC, Investment Advisers Act Release No. 4830 (Dec. 21, 2017).

into such arrangement, that provides for acceleration upon sale of a portfolio company be disclosed in fund marketing materials.

## MNPI/Code of Ethics

OCIE has observed the following deficiencies regarding private fund advisers' obligation to establish, maintain and enforce written policies and procedures to prevent the misuse of MNPI pursuant to Section 204A of the Investment Advisers Act of 1940 (as amended, the Advisers Act), and to adopt and maintain a code of ethics pursuant to Rule 204A-1 of the Advisers Act:

- *Section 204A* – OCIE has observed that private fund advisers did not maintain or enforce adequate written policies and procedures designed to prevent the misuse of MNPI. OCIE specifically has cited the following issues, which private fund advisers should consider including into their policies and procedures:
    - Risks that MNPI might be exchanged posed by employees interacting with (1) insiders of publicly traded companies, (2) outside consultants arranged by "expert network" firms or (3) "value added investors" such as corporate executives or financial professional investors.
    - Risks where employees could obtain MNPI through their ability to access office space or systems where the private fund adviser or its affiliates possessed MNPI.
    - Risks posed by employees who periodically had access to MNPI about issuers of public securities.
- *Code of Ethics Rule* – OCIE has observed that some private fund advisers failed to establish, maintain and enforce provisions in their code of ethics reasonably designed to prevent the misuse of MNPI, as shown in the following examples:
    - Advisers did not enforce trading restrictions on securities placed on the "Restricted list" or did not have sufficient policies for adding securities to, or removing securities, from such lists.
    - Advisers failed to enforce requirements in their codes of ethics regarding the receipt of gifts and entertainment from third parties.
    - Advisers 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 Rule 204A-1. Advisers also failed to identify correctly certain individuals as "access persons."

## Conclusion

Risk Alerts anticipate the particular areas of focus during upcoming OCIE examinations. Private fund advisers should review the issues addressed by this Risk Alert and be prepared to update their disclosure materials and policies and procedures accordingly.

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