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SEC Releases Risk Alert Identifying Common Private Equity and Hedge Fund Compliance Deficiencies

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On June 23rd, the staff of the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) issued a new risk alert entitled "Observations from Examinations of Investment Advisers Managing Private Funds." The risk alert focuses on deficiencies identified in the course of examinations of registered investment advisers that manage private equity funds and/or hedge funds. The risk alert noted that over 36% of investment advisers registered with the Commission manage private funds, and that OCIE continues to examine hundreds of private fund advisers each year.

The risk alert identifies three main areas of noted compliance deficiencies: (i) conflicts of interest; (ii) fees and expenses; and (iii) policies and procedures relating to preventing the misuse of material non-public information. Within each area, the risk alert identifies several specific deficiencies observed in examinations, many of which have been the subject of one or more enforcement actions with private fund advisers over the past several years. More often, however, these types of infractions have been addressed by deficiency letters issued by OCIE examiners. Although it does not break any new ground, the risk alert serves as a valuable reminder of some basic steps advisers can take to reduce and hopefully avoid deficiencies in these areas.

Conflicts of Interest

Conflicts of interest that arise with respect to private fund advisers and the private funds they manage remains a significant area of focus for the SEC staff. Last year, the identification and disclosure of conflicts of interest were a major part of the SEC's Interpretation Regarding Standard of Conduct for Investment Advisers published on June 5, 2019.

The risk alert identifies nine specific areas of conflicts of interest that OCIE staff had observed as appearing to be "inadequately" disclosed. In certain examples provided by the SEC staff, it is unclear why the conflict observed was material to the advisory relationship. Moreover, the risk alert did not explicitly address the questions of when and to whom the disclosure must be made to obtain the necessary consent to the conflict under the Investment Advisers Act of 1940 (Act). Use of the term "inadequate" appears to have been intended to avoid these sometimes complex issues.

Allocations of Investments – The staff observed private fund advisers that did not provide adequate disclosure about conflicts involving allocations of investment among clients, including those that invested alongside flagship funds, sub-advised mutual funds, collateralized loan obligation funds, and separately managed accounts (SMAs). In some cases, private fund advisers preferentially allocated limited investment opportunities to favored clients (including co-investment vehicles). In addition, the staff noted that advisers allocated securities (presumably purchased in the course of a trading day) at different prices or not in accordance with the disclosed allocation practices.

Multiple Clients Investing in the Same Portfolio Company – The staff observed private fund advisers that did not provide adequate disclosure about conflicts created when private fund clients invest at different levels of a capital structure (for example, both equity and debt).

Financial Relationships with 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 seed investors in the adviser's private funds. In other cases, these select investors had economic interests in the adviser (for example, select investors provided credit facilities or other financing to the adviser or the private funds).

Preferential Liquidity Rights – The staff observed private fund advisers that (i) entered into side letter agreements provided special terms, including preferential liquidity terms, but did not provide adequate disclosure about these side letters, and (ii) set up undisclosed side-by-side vehicles or SMAs that invested alongside the flagship fund, but which had preferential liquidity terms.

Interests in Recommended Investments – The staff observed private fund advisers that did not provide adequate disclosure of interests they (and their principals and employees) had in investments recommended to clients.

Co-Investments – The staff observed private fund advisers that failed to adequately disclose allocation conflicts in co-investment arrangements, and private fund advisers that fully disclosed the allocation conflicts but failed to follow their own allocation policies.

Service Providers – The staff observed the failure of certain private fund advisers to adequately disclose conflicts when they caused the fund to engage service providers that they control, and the failure of certain private fund advisers to disclose financial benefits they received from a service provider when they caused the fund to engage it.

Fund Restructurings – The staff observed private fund advisers that (i) purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the value of the fund interests, (ii) did not provide adequate disclosure about investor options during restructurings, and (iii) 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 such conflicts to investors.

Cross-Transactions – The staff observed private fund advisers that 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 the clients.

Fees and Expenses

The risk alert also noted four fee and expense compliance issues.

Allocation of Fees and Expenses – Addressing once again the main theme of recent examinations of private equity fund advisers, the staff observed continued issues with allocation of 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 co-investment vehicles. In addition, the staff observed private equity advisers who (i) charged private funds for expenses that the adviser should bear under the relevant agreements, (ii) failed to comply with contractual limits on expenses that could be charged to the fund, and (iii) failed to follow their own travel and entertainment expense policies.

Operating Partners – The staff observed private fund advisers that did not provide adequate disclosure regarding the role and compensation of operating partners and who would bear the cost of their services.

Valuation – The staff observed private fund advisers that did not value client assets in accordance with their valuation processes or in accordance with methods disclosed to clients (such as that the assets would be valued in accordance with GAAP), potentially leading to overcharging management fees and carried interest.

Monitoring / Board / Deal Fees and Fee Offsets – The staff observed private fund advisers that failed to correctly calculate various fees paid by their portfolio companies and fee offsets in accordance with disclosures. In addition, the staff observed that in some cases, advisers properly disclosed fee and fee offsets but did not have adequate policies and procedures in place to prevent overpayment of the adviser.

Policies and Procedures Relating to Material Non-Public Information (MNPI)

The risk alert also noted compliance issues under (i) Section 204A of the Act, which requires all investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI, and (ii) the personal securities transaction reporting required of "access persons" pursuant to Rule 204A-1 of the Act (the Code of Ethics Rule).

Insider Trading Policies – The staff observed private fund advisers that failed to address compliance risks posed by their employees interacting with insiders of publicly-traded companies, consultants arranged by "expert network" firms, and "value added investors" (e.g., corporate executives who have information about investments) in order to assess whether MNPI could have been exchanged. In addition the staff expressed concern that in some cases adviser personnel could obtain MNPI through their ability to access office space or systems of the adviser or its affiliates that possessed MNPI, and may periodically have access to MNPI about issuers of public securities, for example, in connection with a PIPE (private investment in public equity).

Codes of Ethics – The staff observed private fund advisers that (i) did not enforce trading restrictions on securities that had been placed on the adviser's "restricted list," and/or had codes of ethics that provided for the use of restricted lists but did not have policies and procedures for maintaining a current list, (ii) failed to enforce gifts and entertainment policies, and (iii) failed to require access persons to submit transactions and holdings reports on a timely basis or to submit certain personal securities transactions for preclearance. In addition, some advisers failed to correctly identify certain individuals as "access persons" under their code of ethics for purposes of reviewing personal securities transactions.

Conclusion

The risk alert reflects a number of issues identified in SEC enforcement settlements and staff statements released in recent years. Accordingly, private fund advisers can expect that the OCIE staff will continue to focus on these areas in the course of examinations to determine whether advisers are meeting their obligation to adopt and implement written policies and procedures reasonably designed to prevent violations of the Act.

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