SEC Observations from Examinations of Investment Advisers Managing Private Funds

Background: On June 23, 2020, the U.S. Securities & Exchange Commission ("SEC") released a Risk Alert that provided an overview of compliance issues observed by the SEC Office of Compliance Inspections and Examinations (OCIE) in their examinations of registered advisers that manage private funds. The Risk Alert discusses three general areas of deficiencies that the OCIE has identified in their examinations of private funds: conflicts of interest, fees and expenses, and policies and procedures relating to the use of material non-public information (which could result in insider trading activity).

Unlike some previous SEC updates about OCIE inspections, this Risk Alert was released as a memo rather than a public speech (see the Spreading Sunshine in Private Equity speech). Additionally, the Risk Alert made no reference to the amount of funds reviewed that had deficiencies vs. those that did not have deficiencies. This is generally in line with the current approach of the current SEC leadership to not widely publicize examination and enforcement efforts in the private fund market. ILPA has encouraged the SEC leadership to share this type of private fund examination information with the marketplace to ensure investors are better informed to conduct due diligence when investing.

We encourage ILPA members to review the deficiencies below and review the activities of the managers you invest with to ensure these practices are not taking place:

I. **Conflicts of Interest**: The SEC has observed multiple types of conflicts of interest that were inadequately disclosed and were therefore deficiencies under Section 206 or Rule 206(4)-8 of the Investment Advisers Act of 1940.[1] Potential deficiencies that the SEC observed include:

A. *Conflicts related to allocations of investments*: SEC staff observed that private fund advisers did not provide adequate disclosure about conflicts relating to allocations of investments among clients[2], including to the advisers' flagship

[1] Section 206 prohibits investments advisers from engaging in fraud or deceit upon a client or prospective client. It requires investment advisers to make full and fair disclosures of all conflicts of interest. Rule 206(4)-8 prohibits investment advisers of pooled vehicles from making untrue statements, omitting material facts, or otherwise engaging in fraudulent, deceptive, or manipulative acts with respect to individual investors in a pooled vehicle.

[2] Please note that under the Investment Advisers Act, the client is generally considered to be the fund, not the individual LPs within the fund.

funds, co-investment vehicles, collateralized loan obligation ("CLO") funds, and separately managed accounts ("SMAs"). For example:

- Private fund advisers preferentially allocated limited investment opportunities to new clients, higher fee-paying clients, or to proprietary accounts.
- Private fund advisers allocated securities at different prices or in inequitable amounts among clients without providing adequate disclosure about the allocation process or in a manner inconsistent with the allocation process that was disclosed.

B. *Conflicts related to multiple clients investing in the same portfolio company*: SEC staff observed private fund advisers that did not provide adequate disclosure about conflicts created by directing clients to invest at different levels of the capital structure, such as one client owning debt and another client owning equity in a single portfolio company.

C. *Conflicts related to financial relationships between investors and the adviser*: SEC staff observed private fund advisers that did not provide adequate disclosure about economic relationships between themselves and select investors in their funds. In some cases, these investors acted as initial investors in the advisers' funds (i.e. anchor investors). In other situations, investors had economic interests in the Adviser, for example by having provided credit facilities to the Adviser.

D. *Conflicts related to preferential liquidity rights:* SEC staff observed private fund advisers that entered into side letter agreements that established special terms, including preferential liquidity terms, but did not provide adequate disclosure to other investors about these arrangements. Additionally, SEC staff observed private fund advisers that set up undisclosed side-by-side vehicles or SMAs that invested alongside the fund but had preferential liquidity rights, which created a conflict with the main fund.

E. *Conflicts related to private fund adviser interests in recommended investments*: SEC staff observed private fund advisers that had interests in investments recommended to clients but did not provide adequate disclosure of such conflicts. In some cases, adviser principals and employees had undisclosed preexisting ownership interests or other financial interests such as referral fees or stock options in these investments, creating a financial incentive to recommend them.

F. *Conflicts related to co-investments*: Inadequately disclosed conflicts related to co-investment vehicles and co-investors potentially misled certain investors as to how these co-investments operated. For example, SEC staff observed private fund advisers that disclosed a process for allocating co-investment opportunities

but failed to follow the process that was disclosed. The staff also observed private fund advisers that had agreements with certain investors to provide co-investment opportunities but failed to adequately disclose those arrangements to other investors.

G. *Conflicts related to service providers*: SEC staff observed inadequately disclosed conflicts related to service providers. 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 these conflicts. The staff also observed advisers that had financial incentives for portfolio companies to use certain service providers but failed to adequately disclose these incentives and conflicts to their investors.
   - Additionally, advisers represented to investors that services provided to the fund or portfolio companies by affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated 3rd parties. However, advisers did not have procedures or supporting material to establish if comparable services could be obtained by unaffiliated 3rd parities on better terms, including at a lower cost to the investors.

H. *Conflicts related to fund restructurings:* SEC staff observed private fund advisers that inadequately disclosed conflicts related to fund restructurings and stapled secondary transactions:
   - Advisers purchased fund interests from investors at discounts during fund restructurings without adequate disclosures around the value of the fund interests. Advisers also did not provide adequate disclosure about investor options during the restructurings.
   - Advisers did not provide adequate information in communications regarding fund restructurings. Some Advisers also 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.

I. *Conflicts of interest related to cross-transactions*: SEC staff observed private fund advisers that inadequately disclosed conflicts related to purchases and sales between clients (funds). For example, advisers established the price at which securities would be transferred between client accounts in a way that disadvantaged either the buyer or the seller without adequate disclosure to those parties.

II. **<u>Fees and Expenses:</u>** OCIE staff observed fee and expense transparency issues that appear to be deficiencies under Section 206 or Rule 206(4)-8.

A. *Allocation of fees and expenses*:
- Advisers allocated shared expenses such as broken deal, due diligence, annual meetings, consultants, and insurance costs, among the advisers, investors, and side vehicles such as co-investments in a manner that was inconsistent with stated disclosures, policies, and/or procedures of the Adviser.
- Advisers charged clients for expenses that were not permitted by relevant fund operating agreements, such as adviser-related expenses, including salaries of personnel, regulatory compliance costs, regulator filing costs, and office 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.
- Advisers failed to follow their own travel and entertainment policies as disclosed to investors.

B. *Operating Partners*: SEC staff observed private fund advisers that did not provide adequate disclosure regarding the role and compensation of individuals that may provide services to the fund and/or portfolio companies but are not adviser employees, potentially misleading investors about would bear the costs associated with these services.

C. *Valuations*: SEC staff observed private fund advisers that did not value client assets in accordance with their stated valuation processes or in accordance with disclosures (such as the assets being valued in accordance with GAAP). In some cases, the failure to value fund holdings in accordance with disclosed valuation processes led to overcharging of management fees and carried interest, harming investors.

D. *Monitoring, board, deal fees, and fee offsets*: SEC staff observed private fund advisers that had issues with respect to the receipt of fees from portfolio companies. For example:
- Advisers failed to apply or calculate management fee offsets in accordance with disclosures provided to investors. In some cases, advisers incorrectly allocated portfolio company fees across fund clients. Advisers also failed to offset portfolio company fees paid to affiliates 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.

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

III. **Material non-public information (MNPI):** OCIE staff observed issues that appeared to be deficiencies under Section 204A of the Advisers Act[3] or the Code of Ethics Rule[4]. Both of these SEC rules govern employees at private fund advisers. SEC staff observed that private fund advisers failed to establish, maintain, and enforce policies and procedures designed to prevent the misuse of MNPI and thereby lower the risk of insider trading.

For more information on this Risk Alert and associated issues, please contact Chris Hayes, Senior Policy Counsel, and Brian Hoehn, Associate, at chayes@ilpa.org and bhoehn@ilpa.org respectively.

[3] Section 204A of the Advisers Act 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.

[4] 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 standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.