Simpson Thacher

Regulatory and Enforcement Alert

SEC Risk Alert Highlights Private Fund Adviser Deficiencies

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The Office of Compliance Inspections and Examinations ("OCIE") of the U.S. Securities and Exchange Commission ("SEC") recently published a Risk Alert (the "Risk Alert")[1] highlighting certain compliance issues identified in examinations of registered investment advisers that manage private equity funds or hedge funds (collectively referred to as "private fund advisers"). The Risk Alert discusses three general areas of deficiencies that OCIE has identified in examinations of private fund advisers: (i) conflicts of interest; (ii) fees and expenses; and (iii) policies and procedures relating to material non-public information ("MNPI"). Below is a summary of the compliance issues identified in the Risk Alert and some key takeaways for private fund advisers.

Key Takeaways

- Over the past decade, disclosures in fund offering documents and Form ADV Part 2A regarding conflicts of interest and fees and expenses have grown increasingly granular, driven largely by the wave of enforcement actions the SEC has brought against private fund advisers. The Risk Alert, with its particular focus on the "adequacy" of disclosures in the areas of conflicts and fees and expenses, reinforces the importance of having sufficiently specific disclosure in these areas.
- In addition to focusing on the adequacy of disclosures, the Risk Alert also points to several instances where advisers acted in a manner inconsistent with disclosures (*e.g.*, advisers failed to follow allocation or valuation processes disclosed to investors). As part of the trend toward greater granularity, descriptions in disclosure documents of advisers' practices and processes regarding conflicts and fees and expenses have become more detailed, which has in turn heightened the risk that advisers may fail to follow practices and processes disclosed to investors. The Risk Alert serves to highlight the need for advisers to pay close attention to whether their actual practices and processes align with practices and processes they disclose to investors.
- The conflicts described in the Risk Alert provide advisers with a useful roadmap of the types of conflicts they should address in fund offering documents and Form ADV Part 2A. Advisers should bear in mind, however, that the Risk Alert is not intended to cover the full range of conflicts that could arise over the life of a fund. Along this line, compliance professionals should continually be on the lookout for new arrangements or relationships that might incline an adviser to render advice to a fund that is not disinterested.

[1] *Observations from Examinations of Investment Advisers Managing Private Funds*, Risk Alert, SEC OCIE (June 23, 2020).

- The Risk Alert notably discusses instances where advisers represented that services provided to private funds or portfolio companies by affiliates would be provided on terms no less than favorable than those that could be obtained from unaffiliated third parties, but 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. Advisers that make this sort of representation to investors regarding their affiliated service providers should confirm that they are undertaking adequate market checks with respect to the pricing of such services and retaining sufficient documentation of these market checks.
- Lastly, the Risk Alert addresses deficiencies in the area of MNPI-related policies and procedures. We anticipate that MNPI is likely to become a greater focus area during SEC examinations of private fund advisers, especially in the current market environment, which has heightened the risk that an adviser could come into possession of MNPI. As such, now is a good time for private fund advisers, especially private equity firms with listed portfolio companies and those that engage with public company representatives, to undertake an enhanced review of their MNPI-related policies and procedures.

Conflicts of Interest

The Risk Alert indicates that the OCIE staff observed the following conflicts of interest that appear to be inadequately disclosed and deficiencies under the anti-fraud provisions of the Investment Advisers Act of 1940 (the "Advisers Act").[2]

CONFLICTS RELATED TO ALLOCATIONS OF INVESTMENTS

The staff observed private fund advisers that failed to provide adequate disclosure about conflicts relating to allocations of investments among clients, including the adviser's flagship funds, co-investment vehicles, sub-advised mutual funds, collateralized loan obligation ("CLO") funds and separately managed accounts ("SMAs") (collectively referred to as "clients"). For example, the staff observed private fund advisers that:

- preferentially allocated limited investment opportunities to new clients, clients paying higher fees or proprietary accounts or proprietary-controlled clients, which deprived some investors of limited investment opportunities, without adequate disclosure; and
- allocated securities at different prices, or in apparently inequitable amounts among clients, without providing adequate disclosure about the allocation process or in a manner that was inconsistent with the allocation process disclosed to investors, which caused some investors to pay more for investments or not to receive their equitable allocation of these investments.

[2] *See* Advisers Act Section 206; *see also* Advisers Act Rule 206(4)-8. Section 206 has been interpreted to impose a fiduciary duty on investment advisers. To fulfill this fiduciary duty, an investment adviser must eliminate, or make full and fair disclosure of, all conflicts of interest that might incline the adviser (consciously or unconsciously) to render advice that is not disinterested so that a client can provide informed consent. For disclosure to be full and fair, it should be specific enough that a client can understand the conflict of interest and make an informed decision about whether to provide consent. *See* *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Advisers Act Release No. IA-5248 (June 5, 2019).

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, which deprived investors of important information related to conflicts associated with their investments.

CONFLICTS RELATED TO FINANCIAL RELATIONSHIPS

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 select investors acted as seed investors in the adviser's private funds. In other situations, these select investors had economic interests in the adviser (for example, because they provided credit facilities or other financing to the adviser or the adviser's private fund clients). Failing 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 side letters with select investors 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.

The staff also 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 adequately disclose these special terms 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, when there is a greater likelihood of a financial impact.

CONFLICTS RELATED TO INTERESTS IN RECOMMENDED INVESTMENTS

The staff observed private fund advisers that had interests in investments they recommended to clients but did not provide adequate disclosure concerning these 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 CO-INVESTMENTS

The staff observed inadequately disclosed conflicts related to investments made by co-investment vehicles and other co-investors, potentially misleading certain investors as to how these co-investments operate. For example, the staff observed private fund advisers that disclosed a process for allocating co-investment opportunities among select investors, or among co-investment 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 co-investment opportunities to those investors, but did not provide adequate disclosure about these arrangements to other investors. This lack of adequate disclosure may have caused investors to not understand the scale of co-investments and how co-investment opportunities would be allocated among investors.

CONFLICTS RELATED TO SERVICE PROVIDERS

The 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 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 adequately disclose these incentives and conflicts to investors.

The staff also observed private fund advisers that did not have procedures in place to ensure that they followed their disclosures related to affiliated service providers. For example, advisers represented to investors that the services provided to 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

The staff observed private fund advisers that inadequately disclosed conflicts related to fund restructurings and "stapled secondary transactions."[3] For example, advisers:

- purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the value of the fund interests;
- failed to provide adequate disclosure about investor options during restructurings, potentially impacting investors' decisions;
- failed to provide adequate information in communications with investors about fund restructurings; and
- 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.

[3] As explained in the Risk Alert, 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. The purchaser often offers the existing investors the option to sell their interests or roll their interests into a new, restructured private fund. 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.

CONFLICTS RELATED TO CROSS-TRANSACTIONS

The staff observed private fund advisers that inadequately disclosed conflicts related to purchases and sales between clients (*i.e.*, "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.

Fees and Expenses

The Risk Alert indicates that the OCIE staff observed the following fee and expense issues that appear to be deficiencies under Section 206 of the Advisers Act or Rule 206(4)-8 thereunder.

INACCURATE ALLOCATION OF FEES AND EXPENSES

The staff observed private fund advisers that inaccurately allocated fees and expenses, which in some instances caused investors to overpay management fees. 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 co-investment vehicles, in a manner that was inconsistent with disclosures to investors or policies and procedures;
- 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;
- failed to comply with contractual limits on certain expenses that could be charged to investors, such as legal fees or placement agent fees; and
- failed to follow their own travel and entertainment expense policies.

INADEQUATE DISCLOSURE REGARDING 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.

IMPROPER VALUATIONS OF CLIENT ASSETS

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 (for example, disclosure 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.

ISSUES RELATED TO PORTFOLIO COMPANY FEES

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 referred to as "portfolio company fees"), which in some instances caused investors to overpay management fees. For example, advisers:

- failed to apply or calculate management fee offsets in accordance with disclosures;
- incorrectly allocated portfolio company fees across fund clients, including private fund clients that paid no management fees;
- failed to offset portfolio company fees paid to an affiliate of the adviser that were required to be offset against management fees;
- 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; and
- negotiated long-term monitoring agreements with portfolio companies that they controlled and then accelerated the related monitoring fees upon the sale of the portfolio company, without adequate disclosure of the arrangement to investors.

Material Non-Public Information and Code of Ethics

The Risk Alert indicates that the OCIE staff observed the following issues that appear to be deficiencies under Section 204A of the Advisers Act or Rule 204A-1 thereunder (the "Code of Ethics Rule").[4]

SECTION 204A DEFICIENCIES

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 insiders of publicly traded companies, outside consultants arranged by "expert network" firms, or "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[5];
- Who could obtain MNPI by accessing the office space or systems of the adviser or its affiliates that possessed MNPI; and

[4] 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. Rule 204A-1 under the Advisers Act requires a registered investment adviser to adopt and maintain a code of ethics, which must include standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.

[5] The staff also observed private fund advisers that did not enforce policies and procedures addressing these risks.

- Who periodically had access to MNPI about issuers of public securities (for example, in connection with a private investment in public equity ("PIPE")).

CODE OF ETHICS RULE DEFICIENCIES

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";
- had a code 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, these lists;
- failed to enforce requirements in their code of ethics relating to employees' receipt of gifts and entertainment from third parties;
- failed to require access persons to timely submit transactions and holdings reports or to submit certain personal securities transactions for pre-clearance as required by their policies or the Code of Ethics Rule, as applicable; and
- failed to identify correctly certain individuals as access persons under their code of ethics for purposes of reviewing personal securities transactions.

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