WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

SEC Staff Issues Risk Alert on Examinations of Investment Advisers Managing Private Funds

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The Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") published a risk alert on June 23, 2020,[1] offering its observations and guidance for registered investment advisers that manage private equity funds or hedge funds. The risk alert addresses compliance deficiencies observed by OCIE in three general areas: (i) conflicts of interest; (ii) fees and expenses; and (iii) policies and procedures relating to material non-public information ("MNPI"). The specific issues that OCIE addresses have been the subject of numerous SEC enforcement actions since the adoption of the Dodd-Frank Act, and include investment and expense allocation, coinvestment opportunities, and the use of affiliated services providers by funds and portfolio companies. Notably, the risk alert focuses on inadequate disclosures provided to private fund investors, suggesting that the SEC staff continues to eschew merit-based regulation of specific practices in favor of scrutinizing private fund advisers through the lens of the fiduciary standards under the Investment Advisers Act of 1940 (the "Advisers Act"). In this client alert, we outline the key issues identified in the OCIE risk alert and include references to notable enforcement actions addressing the same or similar issues.

Conflicts of Interest

Under Section 206 of the Advisers Act, an investment adviser must either eliminate or make full and fair disclosure of all conflicts of interest that may induce the adviser to provide clients with advice that is not disinterested. For disclosure to be full and fair, it should be sufficiently specific that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent. Additionally, Rule 206(4)-8 under the Advisers Act prohibits

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

investment advisers from (i) making any materially untrue statements or omissions to any investor or prospective investor in a pooled investment vehicle; or (ii) engaging in fraud, deceit, or manipulation with respect to any investor or prospective investor in a pooled investment vehicle.

OCIE highlighted the following conflicts of interest that appeared to be disclosed inadequately under Section 206 or Rule 206(4)-8:

- Conflicts related to allocations of investments: Advisers did not adequately disclose conflicts relating to allocations of investments among clients. Specifically, OCIE observed that limited investment opportunities were preferentially allocated to new clients, higher fee-paying clients, or proprietary accounts or proprietary-controlled clients. Additionally, securities were allocated at different prices or "inequitable amounts" among investors with either inadequate disclosure about the allocation process or in a manner inconsistent with the disclosed allocation process.
- Conflicts related to multiple clients investing in the same portfolio company: Advisers did not adequately disclose conflicts caused by investing client funds at different levels of a portfolio company's capital structure.
- Conflicts related to financial relationships between investors or clients and the adviser: Advisers did not adequately disclose economic relationships between themselves and select investors or clients.
- Conflicts related to preferential liquidity rights: Advisers did not adequately disclose the existence of side letters that provided for preferential liquidity terms.
- Conflicts related to private fund adviser interests in recommended investments: Advisers did not adequately disclose their preexisting ownership interests or other financial interests (including, but not limited to, referral fees or stock options) in investments recommended to clients.
    - *Notable Enforcement Actions*: *In re* Fortress Investment Management, LLC; *In re* Sica Wealth Management, LLC.[2]
- Conflicts related to coinvestments: Advisers did not adequately disclose conflicts related to investments made by coinvestment vehicles and other coinvestors. Advisers also failed to act in accordance with disclosed processes

[2] *In re* Fortress Investment Management, LLC, Advisers Act Release Nos. 5452 and 5453 (Feb. 27, 2020); *In re* Sica Wealth Management, LLC, Advisers Act Release No. 5453 (Feb. 27, 2020). In these two related enforcement actions, the advisers were charged with failing to disclose adequately conflicts of interest related to their clients' investments in a company. The advisers steered clients to invest in the securities of the company at the same time that the company was compensating the advisers through loans or for consulting services that included introducing investors to the company. The advisers did not adequately disclose this compensation to their advisory clients who invested in the company.

for allocating coinvestment opportunities, and did not adequately disclose enacted agreements with select investors for coinvestment opportunities.

Conflicts related to service providers: Advisers did not adequately disclose service agreements between portfolio companies controlled by private funds and entities controlled by the adviser, its affiliates, or family members of principals. Additionally, advisers did not adequately disclose financial incentives for portfolio companies to use certain service providers. Advisers also represented to investors that services provided by affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated third parties, but did not establish procedures to ensure that the representations were fulfilled.

- *Notable Enforcement Action*: *In re* Monomoy Capital Management, L.P.[3]

Conflicts related to fund restructurings: Advisers did not adequately disclose conflicts related to fund restructurings and stapled secondary transactions. For example, advisers purchased fund interests from investors at discounts without adequately disclosing the value of the fund interests.

Conflicts related to cross-transactions: Advisers did not adequately disclose conflicts related to purchases and sales between clients.

Fees and Expenses

OCIE highlighted the following fee and expense practices that might violate Section 206 or Rule 206(4)-8:

Allocations of fees and expenses: Advisers did not adequately allocate fees and expenses and distributed shared expenses inconsistent with disclosure or policies and procedures. Additionally, advisers (i) charged private fund clients for expenses that were not permitted by the fund operating agreements; (ii) failed to comply with contractual limits on certain expenses that could be charged to investors; and (iii) failed to follow their own travel and entertainment expense policies.

- *Notable Enforcement Actions*: *In re* Lightyear Capital LLC; *In re* First Reserve Management, L.P.; *In re* Cherokee Investment Partners, LLC; *In re* Kohlberg Kravis Roberts & Co. L.P.[4]

3 *In re* Monomoy Capital Management, L.P., Advisers Act Release No. 5485 (April 22, 2020). A private equity fund adviser charged the portfolio companies of a private fund it managed for the services of its in-house “Operations Group.” The adviser did not adequately disclose this practice and the related conflicts in the private fund’s operating documents or otherwise.

4 *In re* Lightyear Capital LLC, Advisers Act Release No. 5096 (Dec. 26, 2018) (charging an adviser with failure to allocate properly certain expenses to coinvestors and to offset properly management fees in connection with undisclosed fee-sharing agreements with certain coinvestors); *In re* First Reserve Management, L.P., Advisers Act Release No. 4529 (Sept. 14, 2016) (sanctioning an adviser for misallocating insurance and subsidiary

Operating Partners: Advisers did not adequately disclose the role and compensation of "operating partners" who provided services to a fund or portfolio company but were not employees of the adviser (and were therefore not compensated out of the adviser's advisory fee revenue earned from the fund).[5]

Valuation: Advisers did not adequately value client assets in accordance with their disclosed valuation processes and, in some instances, overcharged management fees and carried interest.

Monitoring/board/deal fees and fee offsets: Advisers failed to apply management fee offsets in accordance with disclosures and did not enact adequate policies and procedures to track the receipt of fees from portfolio companies, including monitoring fees, board fees, or deal fees. Advisers also failed adequately to disclose to investors monitoring fee agreements with portfolio companies, pursuant to which monitoring fees were accelerated upon the sale of a portfolio company.

- *Notable Enforcement Actions*: *In re* Aisling Capital LLC; *In re* Apollo Management V, L.P.; *In re* Fenway Partners, LLC; *In re* Blackstone Management Partners L.L.C.[6]

expenses to its private equity funds and negotiating a discount for legal services for itself, but not the funds, without appropriate disclosure or effective consent); *In re* Cherokee Investment Partners, LLC, Advisers Act Release No. 4258 (Nov. 5, 2015) (charging two affiliated private fund advisers with improperly allocating to the private funds consulting, legal, and compliance related expenses); *In re* Kohlberg Kravis Roberts & Co. L.P., Advisers Act Release No. 4131 (June 29, 2015) (charging an adviser with allocating all broken deal expenses to its flagship funds and none to its coinvestors).

5 *See also* Spreading Sunshine in Private Equity, Andrew J. Bowden (May 6, 2014) (speech of the then director of OCIE describing the problems with presenting operating partners as part of an adviser's team without disclosing whether fund investors bear the cost of the operating partners).

6 *In re* Aisling Capital LLC, Advisers Act Release No. 4951 (June 29, 2018) (charging an adviser with failure to offset $1.2 million in consulting fees from two portfolio companies held by fund clients as required by the fund's organizational documents); *In re* Apollo Management V, L.P., Advisers Act Release No. 4493 (Aug. 23, 2016) (charging the adviser with failure to disclose to its funds, and to the funds' investors prior to their commitment of capital, that the adviser may accelerate future monitoring fees upon termination of the monitoring agreements); In re Fenway Partners, LLC, Advisers Act Release No. 4253 (Nov. 3, 2015) (sanctioning an adviser for, among other things, inadequate disclosure of conflicts of interest arising from its failure to offset monitoring fees received by an affiliated consulting firm from a fund's portfolio companies against the fund's advisory fee); *In re* Blackstone Management Partners L.L.C., Advisers Act Release No. 4219 (Oct. 7, 2015) (charging an adviser with, among other things, failing to disclose adequately to its funds, and to fund investors prior to their commitment of capital, that the adviser had the authority to accelerate future monitoring fees upon the sale or IPO of a portfolio company).

Policies and Procedures Relating to MNPI

OCIE highlighted the following code of ethics issues that might violate Rule 204A-1 ("Code of Ethics Rule")[7] or Section 204A:

- Code of Ethics Rule: Advisers did not adequately enforce trading restrictions on securities that had been placed on the adviser's "restricted list," and had inadequate policies and procedures for adding securities to, or removing securities from, restricted lists. Additionally, advisers failed to enforce requirements relating to receipt of gifts and entertainment from third parties. Advisers also failed to identify certain individuals as "access persons," and failed to require timely transactions and holdings reports from access persons.

- Section 204A: Advisers did not have adequate policies and procedures to address risks posed by their employees interacting with (i) insiders of publicly traded companies; (ii) outside consultants arranged by "expert network" firms; or (iii) "value added investors" (*e.g.*, corporate executives or financial professional investors who have information about investments). Furthermore, advisers did not address risks posed by their employees who (i) could obtain MNPI through their ability to access office space or systems of the adviser or its affiliates that possessed MNPI; or (ii) periodically had access to MNPI about issuers of public securities (*e.g.*, in connection with a private investment in public equity).

    - *Notable Enforcement Action*: *In re* Cannell Capital, LLC.[8]

Conclusion

The risk alert offers valuable insight into the specific issues that have resulted in a range of enforcement actions against private fund advisers, especially since the adoption of the Dodd-Frank Act. The general focus remains on the areas of (i) conflicts of interest; (ii) fees and expenses; and (iii) policies and procedures relating to MNPI. The SEC staff continues to emphasize fiduciary standards and inadequate disclosures provided to private fund investors over merit-based regulation of specific practices. Private fund advisers should continue to remain vigilant and enhance their compliance programs in these areas.

7 The Code of Ethics Rule requires registered investment advisers to establish, maintain, and enforce a code of ethics that sets out standards of conduct of supervised persons. Rule 204A-1 under the Advisers Act.

8 *See, e.g.*, *In re* Cannell Capital, LLC, Advisers Act Release No. 5441 (Feb. 4, 2020). An adviser specializing in investing in the securities of thinly traded companies with little or no analyst coverage frequently communicated with company insiders and others who had access to MNPI. The adviser failed to follow its written policies and procedures by not maintaining a reasonably designed list of securities that covered persons and their family household members were prohibited from trading after the firm came into possession of potential MNPI. In addition, the adviser's written policies and procedures were not reasonably designed to prevent misuse of MNPI.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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