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Client Alert Commentary

Latham & Watkins Financial Regulatory Practice

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SEC Flags Deficiencies in Private Fund Adviser Compliance

While the findings are not new or surprising, they do serve as a reminder of the regulator's focus on advisers' fiduciary and supervisory duties.

On June 23, 2020, the Securities and Exchange Commission's (SEC's) Office of Compliance Inspections and Examinations (OCIE) published a Risk Alert describing various compliance deficiencies observed in recent examinations of registered investment advisers that manage private equity funds or hedge funds (collectively, private funds).

OCIE highlighted compliance deficiencies in three particular areas, aligned with the areas of concern for private funds previously noted by OCIE its 2020 Examination Priorities: (1) conflicts of interest; (2) fees and expenses; and (3) controls related to material non-public information (MNPI).

Conflicts of Interest

Under Section 206 of the Investment Advisers Act of 1940 (Advisers Act) and the SEC's Interpretation Regarding Standard of Conduct for Investment Advisers adopted alongside Regulation Best Interest and Form CRS Relationship Summary on June 5, 2019, an investment adviser has a fiduciary duty to eliminate or mitigate conflicts of interest with clients. The fiduciary duty of care requires that an adviser not place its own interest ahead of its clients' interests. The fiduciary duty of loyalty requires that an adviser eliminate, or make full and fair disclosure of, conflicts of interest that might cause the adviser to render advice that is not disinterested. The purpose of full and fair disclosure is to allow clients the opportunity to provide informed consent to the conflict.

OCIE highlighted various instances in which investment advisers to private funds either failed to eliminate or failed to adequately disclose conflicts of interest related to:

- Allocation of investments among an adviser's clients
- Multiple client investments in the same portfolio company
- Financial relationships between clients or investors and the adviser
- Preferential rights, such as liquidity terms in side letters
- Interests held by advisers in investments recommended to clients

- Investments made by co-investors or co-investment vehicles
- Relationships between service providers and the adviser
- Fund restructurings and "stapled secondary transactions"
- "Cross-transactions" involving the purchase and sale of investments among clients

Fees and Expenses

OCIE highlighted various investment adviser deficiencies related to fees and expenses, often resulting in clients or investors overpaying, such as:

- Undisclosed or inaccurate allocation of fees and expenses
- Inadequate disclosure of the function and compensation of "operating partners"
- Improper valuation of client assets in accordance with valuation processes or disclosures to clients
- Receipt of fees (*e.g.*, monitoring fees, board fees, or deal fees) from portfolio companies

MNPI / Code of Ethics

Section 204A of the Advisers Act (Section 204A) requires investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by advisers or their associated persons. Advisers Act Rule 204A-1 (Code of Ethics Rule) requires an investment adviser to adopt and maintain a code of ethics, which must set out standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.

OCIE highlighted various investment adviser deficiencies related to failure to properly prevent or address the risk of misuse of MNPI by the adviser's employees, such as:

Section 204A

- Failure to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI
- Failure to address employee interactions with individuals who may have MNPI or the ability to access MNPI, such as insiders of publicly traded companies, outside consultants arranged by "expert network" firms, or "value added investors" that have information about investments

Code of Ethics Rule

- Failure to establish and enforce restrictions in the adviser's code of ethics intended to prevent the misuse of MNPI, including as to an adviser's list of restricted securities, restrictions on receipt of gifts and entertainment from third parties, constraints regarding personal trading accounts, and the designation of certain employees or associated persons as "access persons" who may have access to MNPI

Additional Exam Observations

While the Risk Alert is helpful, it does not cover in detail all the areas the SEC staff has been focused on. In recent exams, for example, the SEC staff has been very focused on the calculation of management

fees, including whether it is appropriate to continue to charge management fees on investments that have been marked down to zero but not yet completely written off. In addition, the SEC staff has been focused on two areas in light of the ongoing COVID-19 pandemic: business continuity plans, and valuations during the first half of 2020 (*e.g.*, whether appropriate subsequent event language is included in performance or valuation information provided to limited partners).

Conclusion

The Risk Alert, although not exhaustive, is a timely reminder to private fund advisers regarding common areas of supervisory deficiency. It reinforces the need to address certain compliance fundamentals, such as implementation of adequate written policies and procedures. Private fund advisers should use the findings in the Risk Alert, in conjunction with self-audits and internal compliance reviews, to gauge the strength of their risk management programs and their overall alignment with regulatory expectations.

Notably, the issues highlighted in the Risk Alert are not unique to US advisers. Regulators in other jurisdictions, including the UK's Financial Conduct Authority, might be concerned to observe any such issues involving advisers or managers falling within their jurisdiction.

The Risk Alert provides a useful framework against which all private fund managers and advisers can self-assess and benchmark against good industry practice. The following Appendix contains a practical compliance checklist to assist with this exercise.

Appendix

A Compliance Checklist for Investment Advisers That Manage Private Funds

Conflicts of Interest

- ☐ Review client contracts and communications to ensure that both general and fact-specific conflict-of-interest disclosures are adequate
- ☐ Review policies related to investment offerings for preferential allocations (or allocations inconsistent with disclosed allocation processes) among different clients and either eliminate or mitigate the conflict with adequate disclosure
- ☐ Review disclosures related to potential conflicts created when clients invest at different levels of capital structure
- ☐ Review disclosures related to potential conflicts caused by special economic relationships with select investors or clients
- ☐ Review disclosures related to potential conflicts caused by preferential liquidity terms established in "side letters" with select investors or clients
- ☐ Review disclosures related to potential conflicts caused by pre-existing ownership interests or other financial interests in recommended investments, such as referral fees or stock options in the investments
- ☐ Review disclosures related to potential conflicts caused by investments made by co-investment vehicles and other co-investors

- ☐ Implement procedures and support to ensure that disclosures related to affiliated service providers are followed
- ☐ Review disclosures related to potential conflicts caused by service providers and private fund advisers, such as through incentive payments or favorable terms
- ☐ Review disclosures related to potential conflicts caused by fund restructurings and "stapled secondary transactions"
- ☐ Review disclosures related to potential conflicts caused by transfer pricing in cross-transactions that may disadvantage the buyer or seller
- ☐ Consider how future conflicts training might feature some of the scenarios highlighted by OCIE

Fees and Expenses

- ☐ Review client contracts and communications to ensure that fee and expense disclosures are adequate
- ☐ Review fee and expense allocation practices to ensure compliance with the fund's disclosures, policies, procedures, and operating agreements
- ☐ Review disclosures related to the function and compensation of "operating partners"
- ☐ Review valuation processes and disclosures to clients in relation to the valuation of client assets
- ☐ Review firm practices to ensure alignment with client disclosures relating to valuations, allocations, monitoring fees, deal fees, board fees, and fee offsets

MNPI

- ☐ Establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI
- ☐ Identify and monitor employee interactions with individuals who may have MNPI
- ☐ Identify and monitor employees who have access to MNPI about issuers of public securities
- ☐ Establish, maintain, and enforce code-of-ethics provisions related to MNPI
- ☐ Enforce trading restrictions based on restricted lists, and maintain defined policies and procedures for adding securities to, or removing securities from, such lists
- ☐ Enforce code-of-ethics restrictions relating to employees' receipt of gifts and entertainment from third parties
- ☐ Require reporting of personal account holdings and trading, and pre-clearance of transactions
- ☐ Identify "access persons" and monitor appropriately

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