Securities Litigation Alert

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SEC Risk Alert Addresses Private Fund Adviser Conflicts of Interest, Fee and Expense Management, and Policies and Procedures Relating to Material Non-Public Information

July 2, 2020

Key Points

- On June 23, 2020, the SEC and OCIE issued its latest Risk Alert describing common deficiencies it has observed in recent examinations of registered investment advisers that manage private equity funds or hedge funds.
- The Risk Alert discusses three areas that private fund advisers should review to shore up their compliance programs: (1) conflicts of interest; (2) fees and expenses; and (3) policies and procedures relating to MNPI.
- The Risk Alert specifically called out the possibility of referrals to the Division of Enforcement—a signal that private fund advisers should pay careful attention to these areas to prepare for their next OCIE examination.

Background

The Office of Compliance Inspections and Examinations' (OCIE) June 23, 2020, Risk Alert focuses on three areas where OCIE has observed compliance deficiencies during recent examinations of registered investment advisers (RIAs) that manage private equity funds or hedge funds (collectively, "private fund advisers"): conflicts of interest, fees and expenses, and policies and procedures relating to material non-public information (MNPI). While the Risk Alert was issued by OCIE, it is a good indicator of the sorts of matters that are likely to trigger future investigations and enforcement actions by the Division of Enforcement. OCIE specifically noted that even though the Securities and Exchange Commission (SEC) has already brought enforcement actions based on a number of issues discussed in the Risk Alert, it "continues to observe some of these practices during examinations." OCIE likely intended this statement to be a warning to RIAs that both OCIE and the Division of Enforcement are likely to take a harder line when confronted with perceived compliance failures in these areas going forward.

Contact Information

If you have any questions concerning this alert, please contact:

Peter I. Altman
Partner
paltman@akingump.com
Los Angeles
+1 310.728.3085

Michael A. Asaro
Partner
masaro@akingump.com
New York
+1 212.872.8100

James Joseph Benjamin Jr.
Partner
jbenjamin@akingump.com
New York
+1 212.872.8091

Paul W. Butler
Partner
pbutler@akingump.com
Washington, D.C.
+1 202.887.4069

Charles F. Connolly
Partner
cconnolly@akingump.com
Washington, D.C.
+1 202.887.4070

Estela Díaz
Parnter
ediaz@akingump.com
New York
+1 212.872.8035

Conflicts of Interest

The first cited category of deficiencies related to conflicts of interest – an area that has been under long-standing SEC scrutiny. The SEC has targeted failures to disclose conflicts of interest as misstatements or misleading omissions of material facts in violation of Section 206 of the Advisers Act and Rule 206(4)-8 thereunder. In doing so, the SEC has relied on its interpretation of an adviser's fiduciary duty of loyalty, which requires conflicts to be disclosed, mitigated (to the extent possible), and subject to informed client consent.[1] In the Risk Alert, OCIE provided specific examples of circumstances where RIA conflict disclosures, or a lack thereof, may have given rise to violations of Section 206 and Rule 206(4)-8. These included:

- **Conflicts related to allocations of investments**: RIAs that did not adequately disclose conflicts related to allocations of investments among their flagship funds, co-investment vehicles, sub-advised mutual funds, collateralized loan obligation funds and separately managed accounts. OCIE expressed concerns that these RIAs gave preferential allocation treatment to new clients, higher fee-paying clients, or proprietary accounts, to the detriment of their other clients. OCIE also took issue with RIA disclosures regarding allocations of securities among clients at different prices or in inequitable amounts.
- **Conflicts related to multiple clients investing in the same portfolio company**: RIAs that failed to provide adequate disclosures about conflicts that arose when they caused clients to invest in different levels of an issuer's capital structure. OCIE cited an example of a situation where one client may own equity, while another may own debt in the same company.
- **Conflicts related to financial relationships between investors or clients and the adviser**: RIAs that had, and failed to disclose, economic relationships with select investors. As an example, OCIE singled out so-called "seed investor" relationships where initial investors often negotiate special terms that are not available to other investors and have negotiated an interest in the investment adviser.
- **Conflicts related to preferential liquidity rights**: RIAs that failed to disclose side letters or separately managed accounts that invest in parallel with the private fund that gave select investors or clients preferential liquidity rights, the exercise of which could negatively impact other investors.
- **Conflicts related to adviser interest in recommended investments**: RIAs that failed to disclose pre-existing ownership or other financial interests in companies that the RIA recommended as investments to clients.
- **Conflicts related to co-investments**: RIAs that did not adequately disclose conflicts related to co-investment vehicles. OCIE noted that such conflicts could arise out of the RIAs' practices for allocating investments among its existing clients and co-investment vehicles, or through arrangements that some of their investors to participate in co-investments but not others.
- **Conflicts related to service providers**: RIAs that failed to disclose their relationships with service providers. For example, OCIE observed RIAs that had undisclosed interests in, or affiliations with, service providers, including at the portfolio company level, or received discounts or incentives from the service provider that benefitted the RIA. OCIE also referenced RIAs' failure to have policies

Mark J. MacDougall
Partner
mmacdougall@akingump.com
Washington, D.C.
+1 202.887.4510

Claudius B. Modesti
Partner
cmodesti@akingump.com
Washington, D.C.
+1 202.887.404

Parvin Daphne Moyne
Partner
pmoyne@akingump.com
New York
+1 212.872.1076

Douglas A. Rappaport
Partner
darappaport@akingump.com
New York
+1 212.872.7412

Jacqueline Yecies
Parnter
jyecies@akingump.com
New York
+1 212.872.7479

Jason M. Daniel
Partner
jdaniel@akingump.com
Dallas
+1 214.969.4209

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and procedures to ensure that they followed the disclosures regarding affiliated service providers, such as by requiring market checks.

- **Conflicts related to fund restructurings**: RIAs that did not adequately disclose conflicts related to fund restructurings. In particular, OCIE focused on disclosures regarding so-called “stapled secondary transactions” where investors were required to agree to participate in a future fund managed by the RIA to restructure their existing investment. OCIE also criticized RIAs for purchasing fund interests from investors at discounts without sufficient disclosures regarding the value of those interests.
- **Conflicts related to cross-transactions**: RIAs with deficient disclosures regarding practices related to cross trades between funds or other clients, especially focusing on pricing methodology.

Fees and Expenses

The Risk Alert also discussed fee and expense issues—another long-standing focus of the SEC—that may also lead to violations of Section 206 and Rule 206(4)-8. In the Risk Alert, OCIE provided specific examples of circumstances where such issues may have given rise to violations of Section 206 and Rule 206(4)-8. These included:

- **Allocation of fees and expenses**: RIAs allocated fees and expenses in a manner inconsistent with their disclosure. OCIE focused specifically on deviations from disclosure regarding (i) allocations of shared expenses among clients, (ii) allocations of adviser expenses, such as of salaries of advisory personnel to clients, (iii) contractual caps on expenses, and (iv) travel and entertainment policies.
- **Operating partners**: RIAs provided inadequate disclosure regarding the roles and compensation of nonemployees of the adviser who provided services to the private fund or portfolio companies.
- **Valuation**: RIAs failed to follow disclosed valuation process for client assets, causing investors to be overcharged management fees and carried interest.
- **Monitoring / board / deal fees and fee offsets**: RIAs either failed to disclose issues concerning the receipt of various fees from portfolio companies, such as board fees, or disclosed them but failed to have or follow procedures related to those fees concerning issues such as management fee offsets. OCIE also focused on the failure to have policies to track fees from portfolio companies.

MNPI Policies and Procedures

Finally, the Risk Alert addressed deficiencies associated with Section 204A of the Advisors Act and Rule 204A-1 promulgated thereunder, which mandate that investment advisers must establish, maintain and enforce policies and procedures that prevent the misuse of MNPI by the adviser or any of its associated persons, along with a code of ethics that addresses the conduct and personal trading activity of advisory personnel. This aspect of the Risk Alert is particularly significant because it follows several recent SEC enforcement actions where RIAs were sanctioned under Section 204A for having deficient material MNPI procedures, even though there were no findings that insider trading actually occurred.

In the Risk Alert, OCIE observed that certain examined RIAs did not satisfy the obligations under Section 204A and Rule 204A-1 because they did not have adequate

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policies and procedures to address the risks posed by their employees handling MNPI. In particular, OCIE criticized RIAs for failing to address risks posed by their employees interacting with: (1) insiders of publicly traded companies; (2) outside consultants arranged by expert network firms; and (3) so-called “value added investors” (e.g., corporate executives or financial professional investors that have information about investments). While the Risk Alert does not say so explicitly, we have seen OCIE cite a failure of firms to track these sorts of interactions and relationships as deficiencies in multiple RIA examinations over the past few years. The Risk Alert also flagged the need to address risks associated with adviser personnel’s physical and network access to MNPI through the RIA or its affiliates, or who had access through confidential information provided by issuers or others in connection with private investment in public equities.

In addition, OCIE observed that certain RIAs did not sufficiently monitor personal securities transactions of adviser personnel, identifying situations where personnel traded in names that appeared on the adviser’s restricted list. OCIE also flagged instances where RIAs lacked defined procedures for adding names to and removing them from their restricted lists, and failed to enforce code of ethics requirements regarding the receipt of gifts and entertainment from third parties. Furthermore, OCIE criticized RIAs for failing to require timely submission of securities transactions and holdings reports by adviser personnel or to mandate preclearance of personal securities transactions. Finally, OCIE noted that certain RIAs did not identify “access persons” pursuant to their codes of ethics when implementing related procedures.

Conclusion

Although the Risk Alert does not identify which deficiencies resulted in referrals to the Division of Enforcement, it signals that private fund advisers should continue to ensure that their policies and procedures are not only sufficient, but enforced. We recommend that private fund advisers review the full list of identified deficiencies in the Risk Alert. While COVID-19 has disrupted certain work flows at the SEC, OCIE examinations continue, and private fund advisers should prepare for future examinations by determining whether they are deficient in any of the areas discussed above. Given the Risk Alert, we believe that examination deficiencies in these areas pose an increased risk of being referred to the Division of Enforcement.

[1] See https://www.akingump.com/en/news-insights/sec-adopts-new-interpretation-of-fiduciary-duty.html for further information regarding the SEC’s interpretation of fiduciary duty.

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