WINSTON & STRAWN LLP

CLIENT ALERT

SEC Issues Risk Alert Relating to Observations from Recent Examinations

JUNE 30, 2020

On June 23, 2020, the Securities and Exchange Commission's (the SEC) Office of Compliance Inspections and Examinations (OCIE) released a Risk Alert (the Risk Alert)[1] relating to certain compliance issues observed by OCIE during examinations of registered investment advisers that manage private equity funds or hedge funds (referred to in the Risk Alert collectively as "private fund advisers").[2]

The Risk Alert focuses on three general topics, which we also have seen as focus areas during client examinations. These topics are: (i) conflicts of interest, which comprises the most significant portion of the Risk Alert, (ii) fees and expenses, and (iii) policies and procedures relating to material non-public information (MNPI). While the Risk Alert does not establish new regulatory obligations, the items discussed in the Risk Alert may serve as a useful roadmap of potential OCIE examination priorities, and should be considered in connection with a private fund adviser's review of its compliance program.

Conflicts of Interest

As mentioned above, a significant portion of the Risk Alert consists of a discussion of compliance issues observed by OCIE during examinations, which relate to conflicts of interest. Many of these topics also are reoccurring subjects seen in recent cases brought against private fund advisers by the SEC's Division of Enforcement.

The Risk Alert focuses on private fund advisers' obligations under Section 206 of the Advisers Act and Advisers Act Rule 206(4)-8[3] to either cure conflicts of interest or provide full and fair disclosure of any such conflicts. The primary categories addressed in this section of the Risk Alert (as well as certain significant areas of concern observed during examinations) are set forth below:

CATEGORY	CERTAIN SIGNIFICANT AREAS OF CONCERN

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Conflicts related to allocations of investments	Preferential allocations given to new and higher-fee paying clients
Conflicts related to multiple clients investing in the same portfolio company	Failure to provide adequate disclosure of potential conflicts where multiple clients are invested in different levels of an investment's capital structure (*e.g.*, some clients in debt and others in equity issued by the same portfolio company)
Conflicts related to financial relationships between investors or clients and the adviser	Failure to provide adequate disclosure of conflicts relating to economic relationships between the adviser and select investors and clients (*e.g.*, "seed investors" and investors providing credit facilities)
Conflicts related to preferential liquidity rights	Side letters granting preferential liquidity terms and the failure to notify investors of the potential harm that can arise when select investors can redeem prior to other investors
Conflicts related to private fund adviser interests in recommended investments	Situations where a private fund adviser may receive undisclosed referral fees or stock options in respect of an investment that also is recommended to clients
Conflicts related to co-investments	Failure of a private fund adviser to disclose to investors that the private fund adviser has granted co-investment rights to other investors and, when disclosed, failure to follow the disclosed investment allocation process

CATEGORY	CERTAIN SIGNIFICANT AREAS OF CONCERN
Conflicts related to service providers	Situations where an adviser has a financial incentive to cause a client's portfolio company to utilize the services of a particular service provider, including service providers affiliated with the adviser or offering the adviser with incentive payments. When service provider conflicts are disclosed, the failure of private fund advisers to establish policies and procedures to compliance with the disclosure (*e.g.*, procedures to establish services are being provided on an arm's-length basis)
Conflicts related to fund restructurings	Failure to provide sufficient information to investors in respect of their options during a restructuring and "stapled secondary transactions" (*i.e.*, an adviser selling a fund's portfolio to a purchaser that commits to invest in the adviser's next private fund)
Conflicts related to cross-transactions	Establishing the price of a security in a manner that disadvantaged a client that is a party to the cross-transaction

One overarching theme of the Risk Alert's discussion of conflicts of interest is that fund investors must be given full and fair disclosure relating to a private fund adviser's conflicts or potential conflicts that may either disadvantage investors (*e.g.*, cause them to incur higher costs vis-à-vis other clients or investors in other client accounts of the private fund adviser) or that may not provide sufficient detail relating to material items that may have otherwise affected an investor's decision to invest (*e.g.*, knowing that other investors in a liquidity fund may have better withdrawal rights).

Private fund advisers to private equity funds should note that the Risk Alert expressly addresses providing adequate disclosure relating to co-investments and restructurings, which have become more prevalent in recent years.

Fees and Expenses

In its discussion of compliance issues observed by OCIE during examinations that relate to fees and expenses, the Risk Alert again cites Section 206 of the Advisers Act and Rule 206(4)-8 thereunder. The primary categories addressed in this section of the Risk Alert (as well as certain significant areas of concern observed during examinations) are set forth below:

CATEGORY	CERTAIN SIGNIFICANT AREAS OF CONCERN
Allocation of fees and expenses	Situations where an adviser allocates fees and expenses in a manner that is inconsistent with disclosures provided to investors, charges expenses that were not disclosed, fails to adhere to contractual limits on expenses, and fails to comply with its own travel and entertainment expense policies
"Operating partners"	Providing disclosures that were potentially misleading as to who would bear the costs associated with persons who are not employees of the adviser, providing services to the fund or portfolio companies
Valuation	Failure to value assets in accordance with valuation policies or disclosures to investors
Monitoring/board/deal fees and fee offsets	Failure to calculate properly management fee offsets, to have policies and procedures to track receipt of portfolio company fees and to disclose that fees such as monitoring fees would be accelerated

One key take-away from the Risk Alert's discussion of fees and expenses is that private fund advisers must provide full and fair disclosure of all expenses, must have adequate policies and procedures tailored to compliance with those disclosures, and must follow such policies and procedures that have been adopted, and disclosures that have been provided.

MNPI/Codes of Ethics

The Risk Alert's discussion of MNPI and Codes of Ethics cites Section 204A of the Advisers Act, which requires investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI, and Advisers Act Rule 204A-1, which requires a registered investment adviser to adopt and maintain a code of ethics, which must, among other things, contain standards of conduct expected of advisory personnel.

The primary categories addressed in this section of the Risk Alert (as well as certain significant areas of concern observed during examinations) are set forth below:

CATEGORY	CERTAIN SIGNIFICANT AREAS OF CONCERN
Section 204A	Failure to address risks such as personnel interacting with: (1) insiders of publicly traded companies, (2) outside consultants, such as those arranged by "expert network" firms, or (3) "value added investors" (*e.g.*, corporate executives and financial professional investors) Failure to address risks where personnel have access to office space and systems of the adviser where such personnel may access MNPI Failure to address risks where personnel may have access to MNPI about issuers of public securities, such as private investments in public equity Failure to enforce established policies and procedures
Code of Ethics Rule	Failure to enforce trading restrictions in respect of restricted lists, and lack of policies and procedures for maintaining restricted lists Failure to enforce gifts and entertainment restrictions Failure to identify "access persons" under the Rule, and failure to require submission of holdings and transactions reports

As with prior sections of the Risk Alert, a key take-away here is that private funds advisers must have adequate policies and procedures tailored to their business, and that such advisers must follow such policies and procedures.

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We can be available at your convenience to discuss the matters addressed in the Risk Alert, as well as the ways such matters may affect your business.

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[1] OCIE's Risk Alert is available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf. Last accessed June 25, 2020.

[2] The Risk Alert notes that more than 36% of SEC-registered investment advisers manage private funds.

[3] Advisers Act Rule 206(4)-8 prohibits fraudulent actions by investment advisers to pooled investment vehicles, and expressly references fund investors and prospective fund investors.

6 Min Read

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