ALERT MEMORANDUM

OCIE Risk Alert Reinforces Key Focus Areas for Private Fund Sponsors

June 26, 2020

On June 23, 2020 the U.S. Securities and Exchange Commission ("SEC") Office of Compliance Inspections and Examinations ("OCIE") issued a risk alert (the "Risk Alert") describing a series of compliance deficiencies it has identified in examinations of investment advisers that manage private equity funds or hedge funds.[1] The Risk Alert broadly focuses on three areas of deficiencies, conflicts of interest, fees and expenses, and protection of material non-public information ("MNPI"), and is notable for its focus on a subset of advisers, rather than on practices or rules that are applicable to all registrants. This approach is, however, consistent with OCIE's stated priority for 2020 to focus on advisers to private funds that have a greater impact on retail investors and serves as a reminder that OCIE remains interested in sponsors of private funds, including private equity funds, even though Chairman Clayton and senior Enforcement Division Staff have made protecting "retail" and "Main Street" investors a priority. Moreover, the Risk Alert highlights deficiencies that, in OCIE's view, would have caused investors in private funds to pay more in fees and expenses than they should have, or caused investors not to be informed of the relevant conflicts of interest concerning the adviser and the fund. This appears to us to be an effort to prompt private fund sponsors to review and enhance their processes or face enforcement referrals and investigations.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

WASHINGTON

Robin M. Bergen
+1 202 974 1514
rbergen@cgsh.com

Zachary L. Baum
+1 202 974 1873
zbaum@cgsh.com

John Lightbourne
+1 202 974 1542
jlightbourne@cgsh.com

NEW YORK

Alexander Janghorbani
+1 212 225 2149
ajanghorbani@cgsh.com

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

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Key Takeaways

— *Raising the bar on the fiduciary duty guidance*. Many of the OCIE's observations allude to the requirements set forth in last year's fiduciary duty guidance[2] for investment advisers and reiterates that advisers must either eliminate or make "full and fair" disclosure of all conflicts of interest. "Full and fair" must be sufficiently specific so that the client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent. The Risk Alert confirms that—consistent with the OCIE's 2020 priorities—compliance with the guidance is a focus area of exams and signals a likely increase in enforcement actions based on failure to follow the guidance. Advisers to private funds may face particular challenges in this area, given the SEC's broad view of "retail"—notwithstanding investor sophistication standards to invest in private funds—and the heightened standards that the guidance applies to relationships with "retail" investors.

— *Allocation policies and procedures.* Whether allocations are made on a "fair and equitable" basis[3] and consistent with an adviser's policies involves significant subjectivity, and this is an area where the SEC and the Staff have not provided substantial guidance. While subjective judgments in the area allow advisers to tailor their policies and practices to their businesses, they also present the risk of hindsight challenge by the SEC Staff. The Risk Alert should serve as a reminder to advisers to regularly review their allocation policies, disclosures and practices to ensure consistency among them and compliance with the policies and disclosures, and to ensure they document that compliance. Advisers with more generic policies should take additional care to thoroughly justify and document each allocation decision to be able to demonstrate compliance with the fair and equitable standard. Further, advisers should ensure regular and robust review and oversight by the compliance or control function.

— *Conflicts from multiple investments within a portfolio company's capital structure.* The Risk Alert highlights deficiencies OCIE Staff observed in disclosure of conflicts among multiple clients that invest in different parts of a company's capital structure. Advisers' fiduciary duties require them to act in the best interests of *each* client, without prioritizing other clients' interests. Advisers should therefore carefully design conflicts processes to ensure that they can demonstrate to the maximum extent possible—and with the benefit of hindsight—that they have satisfied their fiduciary duties to *each* client in these cases. For example, related disclosures should describe with specificity both the potential or actual conflicts of interest and the process advisers plan to follow to manage those conflicts. In some cases, advisers may decide to prohibit or restrict the investment by different clients in different parts of the same company's capital structure absent unusual circumstances such as workouts to avoid situations where clients invested in different parts of the capital structure may have competing interests (e.g., where one client owns debt and another owns equity in a single portfolio company).

— *Clients and investors with preferential rights*. The Risk Alert observes that certain advisers failed to adequately disclose to investors side agreements with other clients or investors that provided preferential rights, including preferential liquidity rights. While OCIE's observations in these areas are relatively straightforward, advisers should ensure that personnel and advisers who prepare and review the adviser's disclosures are informed

[2] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (June 5, 2019). For further discussion of the fiduciary duty guidance please see our client alert, SEC Adopts Best Interest Standard for Broker-Dealers and Fiduciary Duty Guidance for Investment Advisers.

[3] In general, this requires allocations be made fairly and equitably over time to not favor certain clients over others who would otherwise be eligible to invest in the opportunities.

about any preferential rights. For those reviewing related disclosures, best practice is to conduct diligence and identify any benefits, both monetary and non-monetary, that may need to be considered and approved through the advisers conflict process and disclosed.

— *Advisers' relationships with service providers.* SEC Staff has continued to focus on the conflicts posed by service providers who (1) are either under the control of the adviser or its affiliates or principals and their family or (2) provide incentives to the adviser. This is an example of the Staff's focus on more specific and robust disclosure in light of the Fiduciary Duty Guidance. Many advisers in our experience have general disclosure that cover these conflicts and these service providers. Advisers should review these disclosures to ensure they are explicitly addressing these arrangements, and should ensure they have processes in place to document that any provided service is on terms no less favorable than those that could be obtained from another, non-conflicted service provider.

— *MNPI.* Protection of MNPI has been a recent area of focus for the SEC's Enforcement Division, particularly the adequacy of private fund advisers' policies and procedures. Importantly, the SEC has shown a willingness to bring such cases even where no insider trading occurred.[4] OCIE's observations in the Risk Alert highlight that the Staff will continue to cite advisers, and consider enforcement referrals, where trading occurs and policies are not comprehensive or practices do not comply with those polices.

Other Deficiencies Noted by OCIE

Conflicts of Interest

— *Conflicts related to financial relationships between investors or clients and the adviser.* Advisers failed to provide adequate disclosure about economic relationships between themselves and select investors or clients, including with initial investors to a private fund (i.e., "seed investors") or investors with economic interests in the adviser (e.g., having provided credit facilities or other financing to the adviser or its private fund clients).

— *Conflicts related top private fund adviser interests in recommended investments.* Advisers failed to adequately disclose conflicts due to having interests in investments recommended to clients. For example, adviser principals and employees had undisclosed preexisting ownership interests or other financial interests, such as referral fees or stock options in investments.

— *Conflicts related to co-investments.* Advisers failed to adequately disclose conflicts related to investments made by co-investment vehicles and co-investors, such as failing to follow the disclosed process for allocating co-investment opportunities between clients or failing to disclose that the adviser had agreements with certain investors to provide co-investment opportunities to those investors.

— *Conflicts related to fund restructurings.* Advisers failed to inadequately disclose conflicts related to fund restructurings and stapled secondary transactions. For example, advisers (1) purchased fund interests from investors at discounts during restructurings without providing adequate disclosure regarding the value of the fund interests, (2) failed to provide adequate disclosure about investor options during restructurings and (3) required 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 to investors.

— *Conflicts related to cross-transactions.* Advisers failed to adequately disclose conflicts related to purchases and sales between clients, including by establishing the price for the cross-transaction in a

[4] See In the matter of Ares Management LLC, IA Release No. 5510 (May 26, 2020).

way that disadvantaged either the selling or purchasing client.

Fees and Expenses

— *Allocation of fees and expenses*. OCIE noted several examples where advisers inaccurately allocated expenses, including instances where advisers (1) allocated shared expenses (e.g., broken-deal, due diligence, annual meeting, consultants, and insurance costs) in a manner that was inconsistent with disclosures to investors or the adviser's policies and procedures, (2) charged private fund clients for expenses that were not permitted by the relevant fund operating documents, (3) failed to comply with contractual limits on expenses that could be charged to investors and (4) failed to follow the adviser's own travel and entertainment expense policies.

— *"Operating partners."* Advisers failed to provide adequate disclosure on the role and compensation of persons that provide services to a private fund or portfolio company, but are not adviser employees (known as "operating partners").

— *Valuation*. Advisers failed to value client assets in accordance with their valuation processes or in accordance with disclosures to clients. In some cases, OCIE found that this led to the overcharging of management fees and carried interest due to inappropriately overvalued holdings.

— *Monitoring / board / deal fees and fee offsets*.

- Advisers failed to apply or calculate management fee offsets in accordance with relevant disclosures, incorrectly allocated portfolio company fees (e.g., monitoring fees, board fees, or deal fees) across fund clients or failed to offset portfolio company fees paid to an affiliate of the adviser that were required to be offset against management fees.
- Where advisers did disclose management fee offsets, some failed to have adequate policies and procedures to track the receipt of portfolio company fees, including compensation that their employees may have received from portfolio companies.
- Advisers failed to adequately disclose the acceleration of monitoring fees upon the sale of portfolio companies that had entered into long-term monitoring agreements with the advisers.

Code of Ethics

— Advisers failed to enforce requirements in their Code of Ethics relating to employees' receipt of gifts and entertainment from third parties.

— Advisers failed to (1) require access persons to (i) submit transactions and holding reports timely or (ii) submit personal securities transactions for preclearance as required by the adviser's policies or the Ethics Rule and (2) correctly identify certain persons as "access persons."

Conclusion

Ultimately—while the highlighted deficiencies are not particularly new or notable— they are consistent with and repeat prior SEC guidance in this space. Advisers can expect that these areas will continue to be an area of focus for the SEC and potential areas for enforcement if advisers fail to adjust their related practices and disclosures.

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