OCIE Publishes Risk Alert Regarding Private Fund Advisers

On June 23, 2020, the Office of Compliance Inspections and Examinations (“OCIE”) of the Securities and Exchange Commission (“SEC”) published a risk alert (“Risk Alert”) providing an overview of certain compliance issues observed by OCIE in examinations of registered investment advisers that manage private equity funds or hedge funds (“private fund advisers”). The Risk Alert discusses three general areas of deficiencies identified by OCIE: (1) conflicts of interest, (2) fees and expenses and (3) policies and procedures relating to material non-public information (“MNPI”). Many of the deficiencies identified are recurring themes that have been the subject of past enforcement actions and prior risk alerts. To this end, the Risk Alert provides a valuable compilation of key areas that private fund advisers should vigilantly monitor to ensure adequate disclosure, as well as compliance with their internal policies and procedures. We summarize the Risk Alert below.

Conflicts of Interest

The Risk Alert describes numerous conflicts of interest that OCIE staff observed to be inadequately disclosed by private fund advisers. Before listing them, the Risk Alert recaps an investment adviser’s fiduciary duty under Section 206 of the Investment Advisers Act of 1940, as amended (“Advisers Act”), which prohibits investment advisers from employing any device, scheme, or artifice to defraud any client or prospective client, and from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Citing the SEC’s interpretative release on investment adviser standard of conduct published last summer, the Risk Alert states that an investment adviser’s fiduciary duty includes both a duty of care and a duty of loyalty. To satisfy its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, including with respect to all conflicts of interest which might incentivize an investment adviser to render advice that is not disinterested, so that a client can provide informed consent to the conflict. In addition, Advisers Act Rule 206(4)-8 prohibits investment advisers to pooled investment vehicles from making material misstatements or omissions to investors or prospective investors in pooled investment vehicles or otherwise engaging in fraudulent activity with respect to such investors or prospective investors.

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1 Risk Alert, Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020).
3 “Pooled investment vehicle” is defined for this purpose to include any company that would be an investment company under section 3(a) of the Investment Company Act of 1940, as amended, but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act. Rule 206(4)-8(b).
The Risk Alert describes the following conflicts of interest that OCIE staff observed as appearing to be deficiencies under Section 206 or Rule 206(4)-8:

- **Conflicts related to allocations of investments.** OCIE staff observed private fund advisers that preferentially allocated limited investment opportunities to new clients, higher fee-paying clients, or proprietary accounts or proprietary-controlled clients. OCIE staff also observed private fund advisers that allocated securities at different prices or in inequitable amounts among clients without providing adequate disclosure or in a manner inconsistent with disclosures regarding investment allocations provided to clients.

- **Conflicts related to multiple clients investing in the same portfolio company.** OCIE staff observed private fund advisers that did not provide adequate disclosure about conflicts created when clients invest in different levels of the capital structure of the same issuer.

- **Conflicts related to financial relationships between investors or clients and the adviser.** OCIE staff observed private fund advisers that did not provide adequate disclosure about economic arrangements between themselves and select investors or clients (for example, economic interests in the adviser provided to seed investors or investors that provide credit facilities or other financing to the adviser or the adviser’s private fund clients).

- **Conflicts related to preferential liquidity rights.** OCIE staff observed private fund advisers that did not adequately disclose that they had (i) entered into side letters establishing special terms, including preferential liquidity terms, and (ii) set up parallel vehicles or separately managed accounts that invested alongside the flagship fund, but had preferential liquidity terms.

- **Conflicts related to private fund adviser interests in recommended investments.** OCIE staff observed private fund advisers that failed to adequately disclose their interests in investments recommended to clients, including preexisting ownership or other financial interests, such as referral fees or stock options in the investments.

- **Conflicts related to coinvestments.** OCIE staff observed private fund advisers that failed to (i) provide adequate disclosure to investors regarding agreements with certain other investors to provide them with coinvestment opportunities and (ii) follow the coinvestment allocation process disclosed to private fund investors.

- **Conflicts related to service providers.** OCIE staff observed private fund advisers that (i) did not adequately disclose conflicts relating to the use of affiliated service providers, (ii) failed to adequately disclose the existence of financial incentives (such as incentive payments from discount programs) for portfolio companies to use certain service providers, and (iii) did not have in place procedures to ensure that they acted in accordance with their disclosures to investors where they had represented that services provided by affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated third parties.

- **Conflicts related to fund restructurings.** OCIE staff observed private fund advisers that (i) purchased fund interests from investors at discounts during restructurings without adequate disclosure regarding the value of the fund interests, (ii) failed to provide adequate disclosure about investor options during restructurings, and (iii) required potential purchasers 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. OCIE staff observed private fund advisers that did not adequately disclose conflicts relating to cross transactions. For example, the staff found that certain advisers established the price at which securities would be transferred between client accounts in a way that disadvantaged one of the clients without adequate disclosure.

Fees and Expenses

The Risk Alert describes the following issues related to fees and expenses that OCIE staff observed as appearing to be deficiencies under Section 206 or Rule 206(4)-8:

- **Allocation of fees and expenses.** OCIE staff observed private fund advisers that inaccurately allocated fees and expenses, causing investors to overpay expenses, including by (i) allocating shared expenses, such as broken-deal expenses and insurance costs, in a manner that was inconsistent with disclosures to investors or the applicable policies and procedures, (ii) charging private fund clients for expenses that were not permitted by the relevant fund documents (such as adviser-related expenses like salaries of adviser personnel, compliance, regulatory filings, and office expenses), (iii) failing to comply with contractual limits on certain expenses that could be charged to investors (such as legal fees or placement agent fees), and (iv) failing to follow their own travel and entertainment expense policies.

- **Operating partners.** OCIE staff observed private fund advisers that did not provide adequate disclosure regarding the role and compensation of operating partners, including disclosure regarding who would bear the costs associated with the services of the operating partners.

- **Valuation.** OCIE staff observed private fund advisers that did not value client assets in accordance with their valuation processes or disclosures to clients. In certain cases, OCIE staff observed that this failure resulted in the overcharging of management fees and carried interest due to inappropriately overvalued holdings.

- **Monitoring/board/deal fees and fee offsets.** OCIE staff observed private fund advisers that had issues with respect to the receipt of fees from portfolio companies, including monitoring fees, board fees, and deal fees (“portfolio company fees”). For example, OCIE staff observed private fund advisers that (i) failed to apply or calculate management fee offsets in accordance with disclosures to investors, (ii) incorrectly allocated portfolio company fees across fund clients, (iii) did not have adequate policies and procedures to track receipt of portfolio company fees, despite disclosing to investors that such fees would be offset against the management fee, and (iv) accelerated monitoring fees upon the sale of a portfolio company without adequate disclosure of the arrangement to investors.

MNPI/Code of Ethics

The Risk Alert describes issues related to 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 by the adviser or its associated persons. In addition, Advisers Act Rule 204A-1 requires a registered investment adviser to adopt and maintain a code of ethics setting forth standards of conduct expected of advisory personnel and addressing conflicts that arise from personal trading by advisory personnel. The rule requires, among other things, that an adviser’s “access persons” submit

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4 “Access person” is defined to mean an adviser’s partners, officers, directors (or other person occupying a similar status or performing similar functions) and employees (or any other person who provides investment advice on
The Risk Alert describes the following issues that OCIE staff observed as appearing to be deficiencies under Section 204A or Rule 204A-1.

- **Section 204A.** OCIE staff observed private fund advisers that failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI as required by Section 204A. For example, OCIE staff observed private fund advisers that did not address risks posed by their employees (i) interacting with insiders of publicly-traded companies, outside consultants arranged by “expert network” firms, or “value added investors” (e.g., corporate executives or financial professional investors that have information about investments) in order to assess whether MNPI could have been exchanged, (ii) who could obtain MNPI through their ability to access office space or systems of the adviser or its affiliates that possessed MNPI, and (iii) who periodically had access to MNPI about issuers of public securities, for example, in connection with a private investment in public equity.

- **Rule 204A-1.** OCIE staff observed private fund advisers that failed to establish, maintain, and enforce provisions in their code of ethics reasonably designed to prevent the misuse of MNPI. For example, OCIE staff observed private fund advisers that (i) did not enforce trading restrictions on securities placed on the adviser’s restricted list, (ii) did not enforce requirements in their code of ethics relating to employees’ receipt of gifts and entertainment from third parties, (iii) failed to require access persons to submit personal trading reports or preclear certain personal securities transactions as required by the adviser’s code of ethics, and (iv) failed to identify certain individuals as “access persons” under their code of ethics for purposes of reviewing personal securities transactions.

The Risk Alert encourages private fund advisers to review their practices and written policies and procedures, including the implementation thereof, in order to address the issues discussed in the Risk Alert.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:
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