

# Déjà Vu? SEC Reiterates Concerns with Private Fund Advisers

29 June 2020

On June 23, the Office of Compliance Inspections and Examinations (“OCIE”) of the U.S. Securities and Exchange Commission (the “SEC”) published a risk alert (the “Risk Alert”) concerning certain compliance issues observed by OCIE in its examinations of SEC-registered private fund advisers.<sup>1</sup>

The Risk Alert focuses on OCIE’s findings from examinations of private fund advisers, presumably over the past several years. Importantly, we believe that the Risk Alert does not identify any new risks or findings that have not been previously identified by the SEC staff in, primarily, SEC enforcement actions or speeches by SEC staff. In fact, these categories of deficiencies were most recently emphasized in OCIE’s 2020 Examination Priorities with respect to private fund advisers.<sup>2</sup> As a result, the timing and substance of the Risk Alert suggest that OCIE is merely providing a reminder rather than signaling efforts to move in a new direction. Moreover, OCIE notes that “many” private fund advisers have already modified their practices to address the issues identified in the Risk Alert, although, in our experience, most if not all private fund advisers have already taken such steps. Because the Risk Alert does not appear to differentiate between the different categories of private funds, the cited deficiencies may have arisen in the context of examinations of hedge funds but may not have particular applicability to private equity funds (and *vice versa*).

## Primary Deficiencies

The Risk Alert identified three categories of deficiencies: (i) conflicts of interest, (ii) fees and expenses, and (iii) the protection of material non-public information (“MNPI”).

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<sup>1</sup> SEC OCIE, Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), available at <https://www.sec.gov/ocie/announcement/risk-alert-private-funds>.

<sup>2</sup> SEC OCIE, 2020 Examination Priorities (Jan. 7, 2020).

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## I. Conflicts of Interest

The Risk Alert focuses on conflicts of interest and emphasizes the following specific sub-categories of conflicts of interest: (i) the allocation of investment opportunities between clients (particularly, preferential allocations without adequate disclosure, the allocation of securities at different prices or inequitable amounts between clients, and the allocation between a flagship fund and a co-investment vehicle);<sup>3</sup> (ii) multiple clients investing in the same portfolio company (particularly where the clients are investing at different levels of the capital structure);<sup>4</sup> (iii) financial relationships between investors or clients and the private fund adviser, including conflicts associated with seed investors and investors who have economic interests in the adviser (such as financings to the adviser or its private fund clients);<sup>5</sup> (iv) preferential liquidity rights granted to select investors in side letters or for side-by-side vehicles or SMAs;<sup>6</sup> (v) a private fund adviser's interest in recommended investments, such as where the adviser's principals and employees had undisclosed ownership or other financial interests (e.g., referral fees or stock options) in investments recommended to clients;<sup>7</sup> (vi) the allocation of co-investment opportunities among investors (e.g., certain investors with undisclosed preferential rights);<sup>8</sup> (vii) the retention of service providers, particularly service providers controlled by the adviser, its affiliates or family members of principals without adequate disclosure of conflict,<sup>9</sup> inadequate procedures for ensuring compliance with disclosures,<sup>10</sup> and where there are other financial incentives, such as discount programs for using certain service providers;<sup>11</sup> (viii) fund restructurings, including with

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<sup>3</sup> Commission Interpretation Regarding Standard of Conduct for Investment Advisers, SEC Release No. IA-5248 (Jun. 5, 2019); Director Carlo V. di Florio, Private Equity International's Private Fund Compliance Speech (May 3, 2011) (the "2011 Speech"); Director Carlo V. di Florio, Conflicts of Interest and Risk Governance (Oct. 22, 2012) (the "2012 Speech" and together with the "2011 Speech, referred to herein as "Florio").

<sup>4</sup> In the matter of JH Partners, LLC, Release No. 4276 (Nov. 23, 2015) (referred to herein as "JH Partners"). See also *supra* note 3, Florio.

<sup>5</sup> In the matter of Consulting Services Group, LLC, Release No. 4000 (Jan. 16, 2015).

<sup>6</sup> *Supra* note 3, Florio.

<sup>7</sup> In the matter of Blackstreet Capital Management, LLC and Murry N. Gunty, Release No. 77959 (Jun. 1, 2016) (referred to herein as "Blackstreet"). See also *supra* note 4, JH Partners.

<sup>8</sup> Acting Director Marc Wyatt, Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015) (referred to herein as "Wyatt").

<sup>9</sup> Director Andrew J. Bowden, Private Equity International (PEI), Private Fund Compliance Forum 2014 (May 6, 2015) (referred to herein as "Bowden"); in the matter of Fenway Partners, LLC, Peter Lamm, William Gregory Smart, Timothy Mayhew Jr., and Walter Wiacek, CPA, Release No. 4253 (Nov. 3, 2015).

<sup>10</sup> *Supra* note 8, Wyatt.

<sup>11</sup> In the matter of Yucaipa Master Manager, LLC, Release No. 5074 (Dec. 23, 2018) (referred to herein as "Yucaipa"); in the matter of Centre Partners Management, LLC, Release No. 4604 (Jan. 10, 2017); in the matter of First Reserve Management, L.P., Release No. 4529 (Sept. 14, 2016) (referred to herein as "First Reserve"); in the matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C.,

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respect to the purchase of fund interests from investors at discounts and investor options during fund restructurings<sup>12</sup> and stapled secondary transactions;<sup>13</sup> and (ix) cross transactions, where the price was established “in a way that disadvantaged either the selling or purchasing client.”<sup>14</sup>

## II. Fees and Expenses

The Risk Alert’s second major area of focus relates to the disclosure and allocation of fees and expenses.

With respect to the disclosure and allocation of fees and expenses, the Risk Alert highlighted (i) the allocation of shared expenses in a manner that was inconsistent with disclosures to investors;<sup>15</sup> (ii) the allocation of expenses that are not permitted by the fund operating agreements (e.g., salaries of adviser personnel, compliance, regulatory filings, and office expenses);<sup>16</sup> (iii) the failure to comply with contractual limits (e.g., placement agent fees);<sup>17</sup> (iv) the failure to follow travel and entertainment expense policy; (v) inadequate disclosure of role and compensation of operating partners;<sup>18</sup> (vi) the failure to value client assets in accordance with valuation policy or disclosures to

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and Blackstone Management Partners IV L.L.C., Release No. 4219 (Oct. 7, 2015) (referred to herein as “Blackstone”).

<sup>12</sup> In the matter of VSS Fund Management LLC and Jeffrey T. Stevenson, Release No. 5001 (Sept. 7, 2018).

<sup>13</sup> Co-head of Private Fund Unit Igor Rozenblit, Global Private Equity Conference Speech (May 13, 2015).

<sup>14</sup> In the matter of Paramount Group Real Estate Advisor LLC, Release No. 4726 (Jul. 6, 2017).

<sup>15</sup> In the matter of Lightyear Capital LLC, Release No. 5096 (Dec. 26, 2018) (referred to herein as “Lightyear”); in the matter of Platinum Equity Advisors, LLC, Release No. 4772 (Sept. 21, 2017); in the matter of Kohlberg, Kravis Roberts & Co. L.P., Release No. 4131 (Jun. 29, 2015); in the matter of Lincolnshire Management, Inc., Release No. 3927 (Sept. 22, 2014). *See also supra* note 3, Florio; note 8, Wyatt; note 9, Bowden; note 11, Yucaipa; note 11, First Reserve.

<sup>16</sup> In the matter of Monomoy Capital Management, L.P., Release No. 5485 (Apr. 22, 2020); in the matter of Corinthian Capital Group, LLC, Peter B. Van Raalte, and David F. Tahan, Release No. 5229 (May 6, 2019) (referred to herein as “Corinthian”); in the matter of NB Alternatives Advisers LLC, Release No. 5079 (Dec. 17, 2018); in the matter of Fifth Street Management, LLC, Release No. 10581 (Dec. 3, 2018); in the matter of Potomac Asset Management Company, Inc. and Goodloe E. Byron, Jr., Release No. 4766 (Sept. 11, 2017) (referred to herein as “Potomac”); in the matter of Capital Dynamics, Inc., Release No. 4746 (Aug. 16, 2017); in the matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC, Release No. 4258 (Nov. 5, 2015); in the matter of Alpha Titans, LLC, Timothy P. McCormack, and Kelly D. Kaesker, Esq., Release No. 74828 (Apr. 29, 2015); in the matter of Clean Energy Capital, LLC and Scott A. Brittenham, Release No. 9667 (Oct. 17, 2014). *See also supra* note 7, Blackstreet; note 9, Bowden; note 11, Yucaipa.

<sup>17</sup> *Supra* note 9, Bowden.

<sup>18</sup> *Supra* note 7, Blackstreet; note 9, Bowden.

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clients;<sup>19</sup> (vii) failure to apply, calculate or allocate management fee offsets in accordance with disclosures;<sup>20</sup> (viii) failure to track receipt of portfolio company fees (e.g., operating professionals who receive compensation from portfolio companies);<sup>21</sup> and (ix) inadequate disclosure of long-term monitoring agreements with acceleration upon sale of the portfolio company.<sup>22</sup>

### III. MNPI Policies and Procedures

The Risk Alert also focuses on policies and procedures with respect to the protection of MNPI. While insider trading and protection of MNPI has always been an SEC priority with respect to hedge fund advisers, the staff has also been probing compliance by private equity fund advisers, as highlighted by the recent *Ares* enforcement action.<sup>23</sup>

The Risk Alert noted MNPI policies and procedures that (i) did not address (or were not adequately enforced with respect to) risks posed by interactions with (a) insiders of publicly traded companies,<sup>24</sup> (b) expert networks,<sup>25</sup> and (c) value added investors; (ii) did not address persons who could obtain MNPI through shared office space or systems (or access to office space or systems) of the adviser or its affiliates; and (iii) did not address employees who periodically had access to MNPI about issuers of public securities including in connection with a private investment in public equity.<sup>26</sup>

The Risk Alert also highlighted issues with respect to an investment adviser's Code of Ethics (adopted under Rule 204A-1 under the Investment Advisers Act of 1940) relating to (i) the failure to enforce trading restrictions for securities on an adviser's restricted list or to have adequate policies and procedures for adding and removing securities from an adviser's restricted list;<sup>27</sup> (ii) the failure to enforce requirements relating to receipt of gifts and entertainment; and (iii) the failure to enforce requirements relating to personal

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<sup>19</sup> In the matter of ECP Manager LP, Release No. 5373 (Sept. 27, 2019). *See also supra* note 3, Florio; note 9, Bowden.

<sup>20</sup> In the matter of Aisling Capital LLC, Release No. 4951 (Jun. 29, 2018); WL Ross & Co. LLC, Release No. 4494 (Aug. 24, 2016). *See also supra* note 11, Yucaipa; note 15, Lightyear; note 16, Corinthian; note 16, Potomac

<sup>21</sup> *Supra* note 7, Blackstreet.

<sup>22</sup> In the matter of THL Managers V, LLC, and THL Managers VI, LLC, Release No. 4952 (June 29, 2018); in the matter of TPG Capital Advisors, LLC, Release No. 4830 (Dec. 21, 2017); in the matter of Apollo Management V, L.P., Apollo Management VI, L.P., Apollo Management VII, L.P. and Apollo Commodities Management, L.P., Release No. 4493 (Aug. 23, 2016). *See also supra* note 9, Bowden; note 11, Blackstone.

<sup>23</sup> In the matter of Ares Management LLC, Release No. 5510 (May 26, 2020) (referred to herein as "Ares").

<sup>24</sup> *Supra* note 3, Florio, and note 23, Ares

<sup>25</sup> SEC Brings Expert Network Insider Trading Charges, SEC Press Release 2011-38 (Feb. 3, 2011).

<sup>26</sup> *Supra* note 23, Ares.

<sup>27</sup> In the matter of Sidoti & Company, LLC, Release No. 80024 (Feb. 13, 2017).

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securities transactions reporting and pre-clearance under Rule 204A-1 and (iv) the failure to correctly identify all individuals who are “access persons.”

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Given the SEC’s historical focus on these compliance risk areas and the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which required the registration of most private fund advisers that were not already registered, most private fund advisers have already been reviewed by the SEC and, as appropriate, have enhanced their existing policies and practices. Nevertheless, private fund advisers should continue to review the specific sub-categories and examples discussed in the Risk Alert and consider whether, in light of their firm’s particular practices, additional changes to their compliance policies and procedures are necessary.

Do not hesitate to contact us with any questions.

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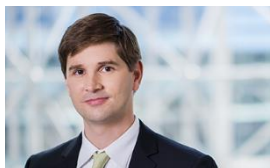


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