Securities Regulation Daily Wrap Up, INVESTMENT ADVISERS—SEC OCIE risk alert highlights private-fund adviser risks, (Jun. 24, 2020)

Securities Regulation Daily Wrap Up

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Many identified deficiencies may have caused investors in private funds to pay more in fees or to remain unaware of relevant conflicts of interest, OCIE said.

The SEC's Office of Compliance Inspections and Examinations has issued a risk alert in connection with examinations of registered investment advisers managing private equity funds and hedge funds. The alert primarily addresses common deficiencies and compliance issues related to fees and expenses and/or inadequate disclosures of conflicts of interest concerning private fund advisers and their respective fund clients. OCIE intends the alert to help advisers enhance compliance and provide investors with more relevant information.

OCIE findings. According to OCIE's risk alert, over 36 percent of registered advisers manage private funds that invest in, among other things, pensions, charities, and endowments. However, OCIE had found three general areas of deficiencies in examining private fund advisers: (1) conflicts of interest; (2) fees and expenses; and (3) policies and procedures relating to material, nonpublic information.

Conflicts. In examinations, OCIE staff observed private fund advisers that did not provide adequate disclosure about conflicts relating to investment allocation. Specifically, OCIE found that certain advisers preferentially allocated limited investment opportunities to new and higher-fee-paying clients and allocated securities at different prices and without providing adequate disclosure. The staff also found firms that failed to make clear disclosures regarding conflicts including those: (1) related to multiple clients investing in the same portfolio company; (2) between investors and the adviser; (3) related to preferential liquidity rights; and (4) connected with recommended investments and co-investments, as well as service providers.

OCIE staff also noted that some private fund advisers did not have procedures in place to disclose conflicts related to fund restructurings. According to OCIE, some advisers purchased interests from investors at discounts during restructurings without adequately disclosing the actual value of the interest, and did not provide adequate information in investor communications about restructurings. According to the staff, some private fund advisers also failed to adequately disclose information regarding cross-transactions among clients.

Fees and expenses. OCIE staff also observed several deficiencies regarding fees and expenses, noting that some private fund advisers have engaged in inaccurate allocations. In particular, the staff noted, advisers allocated shared expenses in a manner inconsistent with disclosures and charged private fund clients for expenses not permitted by relevant operating agreements. Certain private fund advisers also failed to comply with contractual limits on certain expenses and failed to follow their own travel and entertainment expense policies, according to OCIE.

In certain circumstances, OCIE observed, private fund advisers also failed to value client assets in accordance with valuation processes or investor disclosures, and had issues with respect to the receipt of fees from portfolio companies.

Ethics. In addition, OCIE staff found that some private fund advisers failed to establish and maintain policies and procedures designed to prevent the misuse of material, nonpublic information. Specifically, the advisers did not address risks posed by their employees and outside consultants to prevent violations of their respective codes of ethics. Certain advisers also failed to require access persons to submit transactions, holdings reports, and personal transactions for preclearance as required by firm policies, the staff explained.

OCIE encourages private fund advisers to review their practices and written policies and procedures to address these issues, the risk alert concluded.

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