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Practice Update

SEC Issues a Warning to Private Equity Fund Managers

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On June 23, 2020, the Office of Compliance Inspections and Examination (OCIE) of the Securities and Exchange Commission (SEC) published a risk alert (Risk Alert)[1] that highlighted certain compliance deficiencies observed by OCIE in examinations of registered investment advisers that manage private equity funds (each, a PE Manager). If past Risk Alerts are any indication, the deficiencies highlighted in this Risk Alert will be a major focus of future SEC examinations.

The Risk Alert highlights deficiencies in three general areas: (1) Conflicts of Interest; (2) Fees and Expenses; and (3) Personal Trading. A brief summary of the most significant deficiencies follows.

Conflicts of Interest

Recapping the duties imposed on PE Managers under Section 206 of the Investment Advisers Act of 1940, as amended (the Act)[2], the Risk Alert first reminds PE Managers that the duties they owe to their Clients (defined below) include both a duty of care and a duty of loyalty.[3] In order to satisfy its duty of loyalty, a PE Manager must make full and fair disclosure of all conflicts of interest and material facts relating to the advisory relationship, including such facts relating to conflicts of interest that may provide incentive to the PE Manager to provide

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disinterested advice. Such disclosures must be sufficient enough for the Client to be able provide informed consent to the conflict. In addition, Rule 206(4)-8 under the Act prohibits PE Managers to pooled investment vehicles[4] from omitting material facts, making material misstatements, or engaging in any fraudulent scheme, practice, or activity with respect to such investors or prospective investors of private funds (collectively, Investors). The Risk Alert details various areas where conflicts of interests were inadequately disclosed or deficient under Section 206 or Rule 206(4)-8, including:

- *Conflicts related to investment allocation.* Certain PE Managers did not provide adequate disclosure relating to the allocation of investment opportunities among Clients, including flagship funds, co-investment vehicles investing alongside such funds, sub-advised funds, collateralized loan obligation funds, and separately managed accounts (SMAs) (each, a Client).
- *Conflicts related to multiple Clients investing in the same portfolio company*. Certain PE Managers did not provide adequate disclosures about conflicts created by Clients, causing Clients to invest in different securities of a portfolio company, such as one Client owning debt and another Client owning equity, without providing sufficient disclosures relating to the conflicts associated with such investments.
- *Conflicts related to preferential liquidity rights.* Certain PE Managers failed to provide adequate disclosures relating to the existence of side letters with certain investors containing special terms, including preferential liquidity terms. Other PE Managers failed to disclose the existence of side-by-side vehicles or SMAs that contained the same.
- *Conflicts related to PE Manager interests in recommended investments.* Certain PE Managers provided inadequate disclosures relating to the PE Manager's own interests in investments that the PE Manager also recommended to Clients.

- *Conflicts related to co-investments.* Certain PE Managers failed to adequately disclose conflicts related to investments made by co-investment vehicles and other co-investors relating to how each operates including the disclosure related to agreements to provide such opportunities to certain investors as well as the process by which co-investment opportunities were allocated among investors generally.
- *Conflicts related to service providers.* Certain PE Managers failed to disclose the relationship or existence of agreements between the PE Manager and certain service providers controlled by the PE Manager, its affiliates, or family members of principals, that have been hired to provide services to the Clients or portfolio companies and the conflicts the existence of each created.

Fees and Expenses

Again citing Section 206 or Rule 206(4)-8 of the Act, OCIE identified various fee and expense deficiencies, including:

- *Allocation of fees and expenses*. Allocating shared expenses among the PE Managers and their Clients in a manner that was inconsistent with disclosures or other policies and procedures, charging expenses that were not permitted or disclosed in offering documents, failing to comply with contractual limits on expenses charged to Investors, and failing to follow travel and entertainment expense policies.
- *Operating Partners.* Inadequate disclosures or omissions relating to the role and compensation of individuals that may provide services to the Clients or portfolio companies but that are not employees of the PE Manager (often referred to as operating partners).
- *Valuation.* Failure to value Client Assets in accordance with the PE Manager's valuation processes or in accordance with disclosures to Clients, resulting in overcharging Clients.

- *Monitoring/board/deal fees and fee offsets.* Failure to apply or calculate management fee offsets in accordance with disclosures, incorrectly allocated portfolio company fees across Clients, and failed to offset such fees paid to an affiliate of the PE Manager that were required to be offset against management fees. Other PE Managers disclosed management fee offsets but did not have adequate policies and procedures to track the receipt of portfolio company fees, including compensation received from such companies, while others failed to disclose acceleration of monitoring fees relating to long-term monitoring agreements.

Personal Trading

Under Section 204A of the Act, PE Managers are required to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information (MNPI) by the Adviser and its associated persons. Additionally, Rule 204A-1 under the Act (the Code of Ethics Rule) requires PE Managers to adopt and maintain a code of ethics which sets forth standards of conduct expected of advisory personnel and addresses the conflicts that arise from personal trading.OCIE highlighted the following deficiencies with respect to personal trading:

- *Section 204A*. Various PE Managers failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by failing to address the risks posed by their employees (i) interactions with insiders of publicly-traded companies, outside consultants arranged by “expert network” firms, or “value added investors,” (ii) who could obtain MNPI through their ability to access office space or systems of the PE Manager 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.

- *Code of Ethics Rule*. The OCIE staff identified PE Managers that failed to establish, maintain, and enforce provisions of their code of ethics reasonably designed to prevent the misuse of MNPI by failing to enforce: (i) trading restrictions on securities that had been placed on the PE Manager's "restricted list" or not having a "restricted list" at all; (ii) requirements in their code of ethics relating to receipt of gifts and entertainment from third parties; (iii) the use and timely submission of personal transaction reports and the failure to submit preclearance for personal securities transactions; and (iv) the appropriate designation of "access persons"[5] under the code of ethics for purposes of reviewing personal securities transactions.

Conclusion

Many of the deficiencies discussed in the Risk Alert have resulted in costly SEC enforcement actions against PE Managers. While enforcement actions often lead to suspensions, industry bars, and substantial fines, the reputational harm associated with SEC enforcement actions can have a devastating impact on PE Managers. Now is the time for PE Managers to conduct thorough reviews or mock-SEC examinations of their current compliance programs to help ensure examination readiness.

For more information regarding PE Manager compliance obligations, please contact Paul Foley, Chair of Akerman's Investment Management Practice or another member of Akerman's Investment Management Practice.

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[1] Risk Alert, Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020).
[2] Section 206 of the Act prohibits investment advisers from engaging in certain transactions including, directly or indirectly, (i) employing any device, scheme, or artifice to defraud any client or

prospective client (ii) engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client and (iii) engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

[3] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (June 5, 2019).

[4] Under Rule 206(4)-8(b) of the Act, a "pooled investment vehicle" for purposes of this section means 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.

[5] Rule 204A-1(e)(1) of the Act defines "access person" as a PE Manager'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 behalf of the PE Manager and is subject to the supervision and control of the PE Manager) that (i) has access to MNPI regarding any Clients' purchase or sale of securities, or MNPI regarding the portfolio holdings of any reportable fund, or (ii) are involved in making securities recommendations to clients or who have access to such recommendations that are nonpublic.
