

# SEC Observes Common Compliance Issues with Private Fund Advisers

06.24.20

On June 23, 2020, the Office of Compliance Inspections and Examinations (“**OCIE**”) issued a risk alert providing an overview of certain compliance issues observed by the OCIE in examinations of registered investment advisers that manage private funds (the “**Risk Alert**”). The deficiencies discussed in the Risk Alert involved inadequate disclosure of conflicts of interest, inaccurate allocation of fees and expenses, and failure to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information (“**MNPI**”). The Risk Alert highlights common risks and issues the OCIE staff has identified and encourages private fund advisers to assess their supervisory, compliance and other risk management systems related to these risks.

## Inadequate Disclosure of Conflicts of Interest

Under the Investment Advisers Act of 1940 (the “**Advisers Act**”), an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest which might cause an investment adviser to render advice which is not disinterested. The Risk Alert identifies several types of conflicts of interest that the OCIE staff observed to be inadequately disclosed, including conflicts related to:

1. the allocation of investment opportunities between multiple clients of a single adviser;
2. multiple clients investing in the same portfolio company;
3. financial relationships between investors or clients and the adviser, such as “seed deals” and other strategic relationships;
4. preferential rights, especially with respect to liquidity, and terms established with select investors through “side letters;”
5. interests held by the private fund adviser in the recommended investments;
6. investments made by coinvestment vehicles and other coinvestors, potentially misleading certain investors as to how these coinvestments operate;
7. relationships between the adviser and service providers;
8. fund restructuring (i.e., the sale of an existing private fund or the fund’s portfolio to a purchaser) and “stapled secondary transactions” (i.e., a combination of the purchase of a private fund portfolio with an agreement by the purchaser to commit capital to the adviser’s future private fund); and
9. cross-transactions involving the purchase and sale of investments between clients.

It is unclear whether the deficiencies observed by the OCIE staff involved a total lack of disclosure or insufficient disclosures. In order for disclosure to be full and fair under the Advisers Act, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent to such conflict. Private fund advisers are encouraged to review their disclosures and verify that they accurately reflect the conflicts of interest that may exist under the facts and circumstances surrounding an investment in the private fund.

## Inaccurate Allocation of Fees and Expenses

The OCIE staff observed various fee and expense deficiencies including inaccurately allocated fees and expenses that caused certain investors to overpay. Most of the instances highlighted in the Risk Alert involved allocations that were inconsistent with disclosures to investors or policies and procedures and/or not permitted by the relevant fund operating agreements. The Risk Alert highlights the importance of periodically reviewing fee and expense allocation practices to ensure compliance with the fund’s disclosures, procedures and operating agreements.

## Failure to Prevent Misuse of MNPI

The Advisers Act requires investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the adviser or any of its associated persons. Most of the

deficiencies identified in the Risk Alert related to an adviser's failure to properly address the risk of misuse by the adviser's employees. The Risk Alert highlights the importance of establishing, maintaining and enforcing provisions of the adviser's code of ethics related to MNPI, including, for example, (i) correct identification of "access persons" (i.e., those employees who may have access to MNPI), (ii) enforcement of trading restrictions, and (iii) requiring timely submission of transactions and holding reports for preclearance.

In concluding the Risk Alert, OCIE issued its customary admonition encouraging private fund advisers to review their practices and written policies and procedures, including implementation of those policies and procedures to address the issues discussed in the Risk Alert.

**The full text of the Risk Alert may be found here.**

**Contacts:**

Andrew Rosell | 817.420.8261 | [arosell@winstead.com](mailto:arosell@winstead.com)

Jarrold Azopardi | 817.420.8241 | [jazopardi@winstead.com](mailto:jazopardi@winstead.com)

*Disclaimer: Content contained within this news alert provides information on general legal issues and is not intended to provide advice on any specific legal matter or factual situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.*