Private Equity Law Report
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September 1, 2020

CONFLICTS OF INTEREST

OCIE Risk Alert on Private Funds: Key Takeaways for Managers (Part Two of Two)

By Robin L. Barton, *Private Equity Law Report*

On June 23, 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert on observations from examinations of investment advisers that manage PE and hedge funds (Risk Alert). The areas on which the Risk Alert focuses include conflicts of interest; fees and expenses; and material nonpublic information (MNPI) and codes of ethics. As with prior risk alerts, one of the goals of the Risk Alert is to "assist private fund advisers in reviewing and enhancing their compliance programs."

To further that goal, this second article in a two-part series discusses the key takeaways from the Risk Alert for private fund managers and suggests what advisers should do now in response to the Risk Alert. The first article provided an overview of the Risk Alert.

See "Four Essential Elements of a Workable and Effective Private Fund Compliance Program" (Aug. 28, 2014).

Key Takeaways

OCIE Has Renewed Focus on Private Fund Advisers

"Previously, OCIE has said that the themes that it identifies in its annual priorities and risk alerts apply to private fund managers, just like they would to other investment advisers. What is interesting here is to see a Risk Alert entirely dedicated to private fund advisers," observed former Director of OCIE and ACA Compliance Group partner and global chief services officer Carlo di Florio. "OCIE's 2020 Examination Priorities noted a few priorities relating to private fund advisers, including side-by-side management, conflicts of interest and MNPI. This alert builds on those themes. It's the most expansive and detailed coverage since we set up the Private Funds Unit in OCIE while I was there."

See "2020 OCIE Exam Priorities Include New Emphasis on Compliance Programs; Retail Investors Remain Top Focus" (Feb. 25, 2016).

"The Risk Alert is clearly another signal that the SEC is going to continue focusing on private funds. There are approximately 25 staff members in the Private Funds Unit across seven different regions, and they leverage the core investment adviser exam staff to help as well," di Florio continued. "There are certainly going to be more focused, in-depth exams for private fund advisers. We're also seeing equally strong coordination between that unit and the Asset Management Unit in Enforcement, as well as with the Division of Investment Management. It's a really strong and capable team."

See "PLI Panel Discusses 2020 OCIE Priorities and Tips for Fund Managers to Navigate an Examination (Part One of Two)" (Apr. 7, 2020).

The Risk Alert Is Unsurprising but Still Valuable

"The Risk Alert is a consistent drumbeat of the same messages that the SEC staff have been publicly expressing over the last couple of years," remarked Michael J. Osnato, Jr., Simpson Thacher partner and former Chief of the Complex Financial Instruments Unit of the SEC's Division of Enforcement. "It's still important because any time they choose to reinforce a core set of messages, it tells you that those areas continue to be the focus of exams and enforcement. It's telling the industry to remain vigilant because they are as well."

"The Risk Alert is really a compilation of staff positions that have almost all been made publicly in some way, shape or form over the past four years or so, although some of those criticisms go back many years," agreed Brian Daly, partner at Schulte Roth Zabel. "Almost everything in the Risk Alert you can track to some public statement or release from OCIE or an OCIE officer over the past few years." Still, he said, "the alert is a very important document because it provides sort of a top three list of what OCIE is looking at, which I'm phrasing as the 'three C's': conflicts, cash and code."

Genna N. Garver, partner at Troutman Pepper, echoed Daly's observations. "The Risk Alert is the most comprehensive guidance we have seen from the SEC on private fund managers. For each bulleted item, I can think of a prior SEC enforcement action on point. The alert is an inventory of the lessons learned from those actions and from OCIE's exam observations," she explained. "Seeing everything together is what makes this such a useful tool for compliance professionals. These risk alerts are OCIE's way of saying those deficiencies are too prevalent."

For additional insights from Garver, see "The Dos and Don'ts of Investor Calls That Investment Managers Must Consider" (Jun. 16, 2020).

"Leadership in OCIE and the Private Funds Unit have been speaking about these subjects at conferences for several years. But, to see them all together in one treatise on the conflicts of interest; fees and expenses; and MNPI challenges impacting private funds is really compelling and very valuable," observed di Florio. "I'm sure everyone will keep this alert in his or her top drawer or one click away. It's also a reminder to the industry that this is a very active and very specialized unit that is really focused on these issues, together with the broader investment adviser exam team."

Managers Should Expect More Exams, Enforcement Actions

"The takeaway from this alert should be a massive warning," Garver cautioned. "In the past, when guidance like this has come out, it has been followed by increased announcements of SEC enforcement in the same areas."

In fact, several of the sources who spoke to the Private Equity Law Report used the phrase "get your house in order" to describe how fund managers should respond to the Risk Alert in light of the fact that it likely signals more exams – and more enforcement actions.

"The SEC generally – and OCIE in particular – is good at identifying compliance issues and communicating their concerns to the industry to promote compliance, one of the pillars of OCIE's mission. First, the staff will publish its priorities and talk about those issues at conferences," di Florio explained. "Next, they will issue a risk alert to give the industry a

chance to understand the SEC's concerns and get their houses in order. Then, typically you start to see more enforcement actions if firms still aren't getting it right." He added, "We've seen a number of enforcement actions over the years in these areas already, but it's very likely that we'll continue to see more."

"We have definitely seen both document requests and deficiency letters that are much more mapped to and aligned with this Risk Alert because the Private Funds Unit and other offices across the country and the SEC have been focused on these issues for a while," di Florio continued. "I have already seen a new form of an exam document request that homes in on fees and expenses," Garver added.

See "When and How Are Fund Managers Required to Disclose Deficiency Letters to Investors? (Part Three of Three)" (Apr. 23, 2019).

"There's still a pool of sizable PE firms and hedge funds that have yet to be examined. Anybody who has been operating for a few years and has sizable assets under management should expect the phone to ring any day. In some ways, they're the real audience for this alert," Osnato commented. "If you've been examined, was it a difficult exam? Was there an enforcement referral? If so, you're more likely to be reexamined. If you're a manager who came through an exam clean, there's a lot of ground OCIE needs to cover before it comes back to you."

Osnato also said that he believes there will be a wave of exams specifically focusing on MNPI and insider trading in response to the alert.

"Buried at the end of the Risk Alert is probably the most important development and the next big focus area, and it applies equally to hedge and PE: handling MNPI in a secure way. I say that because the markets for the past couple of months have been extremely dislocated," explained Osnato. "Some firms are being extremely opportunistic – trading in securities and instruments they don't typically trade in – and so have less familiarity with the rules of the road. Others are investing in companies they already have touch points with, such as they own bonds and now are buying loans."

"There was a case not too long ago against Ares Management for failure to handle MNPI appropriately. To me, that is the template for what will be a wave of exams – and eventually investigations – focused on MNPI abuses and potentially insider trading in coronavirus markets. I absolutely think that's coming," Osnato continued. "We're actually seeing and sensing existing exams wrapping up pretty quickly because it does feel like there's some pressure to get all of the assets and resources back to the SEC and then redeploy them in a very systematic way to focus on these new issues. That's my impression."

See "SEC Fines Ares Management for Inadequate MNPI Policies and Procedures for Employees on Portfolio Company Boards" (Jun. 30, 2020).

"The Co-Directors of Enforcement issued a statement expressing concern about MNPI and insider trading given the convergence of regulatory relief on filings, market volatility and industry participants working from home, where there might be fewer MNPI controls and higher exposure," added di Florio. "That might be a driver for potentially more exams in that area."

The Focus Remains on Protecting Investors

The SEC's focus under Chair Jay Clayton is typically described as being on protecting retail or "Main Street" investors, but one should

not forget that part of the regulator's overarching mission is to protect investors period. Through that lens, the Risk Alert is consistent with the focus on investor protection.

For example, the Risk Alert notes that more than 36 percent of investment advisers registered with the SEC manage private funds, which frequently have significant investments from pensions, charities, endowments and families – "in other words, a large portion of the investing public that the SEC is meant to protect," noted di Florio. In addition, many of the deficiencies discussed in the Risk Alert may have harmed investors in private funds directly by causing them to pay more in fees and expenses than they should have.

"The Risk Alert is saying that what OCIE cares about are things that really cause harm to investors or clients – not technical violations," Daly agreed. "The three things it chose to bring to advisers' attention are matters that cause actual measurable harm to either investors or the securities market as a whole, which then hurts the average American."

The Alert Reinforces the Commission's View on Conflicts

On June 5, 2019, SEC's Commissioners published the Interpretation Regarding Standard of Conduct for Investment Advisers (Interpretation), which became effective on July 12, 2019. In its discussion of the fiduciary duty, the Interpretation spends a lot of time on conflicts of interest, especially disclosure of them to investors or prospective investors. The final version of the Interpretation confirms that an adviser can meet its duty of loyalty by making full and fair disclosure to its clients of all conflicts of interest that might incline the adviser to render advice that was not disinterested.

Daly pointed out that the Interpretation came from the Commissioners who sit at the top of the SEC. On the other hand, the Risk Alert was issued by OCIE and reinforces the standards for mitigating or disclosing conflicts of interest set forth in the Interpretation, he said.

"The Risk Alert comes from OCIE, which is essentially the cop on the beat. Those are the people who will examine an adviser, and their findings, opinions and conclusions will find their way into deficiency letters and, from time to time, even enforcement referrals," Daly explained. "You want everybody singing from the same hymnal. This Risk Alert is OCIE saying, 'We get it. We read the Interpretation. We internalized it, and we endorse it.'"

See our three-part series "Navigating the SEC's Interpretation Regarding an Investment Adviser's Standard of Conduct": What It Means to Be a Fiduciary (Dec. 3, 2019); Six Tools to Systematically Identify Conflicts of Interest (Dec. 10, 2019); and Three Tools to Systematically Monitor Conflicts of Interest (Dec. 17, 2019).

Managing Private Funds Is Increasingly Complicated

The issues highlighted in the Risk Alert are not new. In fact, some of the same issues were raised in prior risk alerts. For example, in 2017, OCIE released a risk alert on the five most common compliance issues identified in deficiency letters to investment advisers, which included failure to follow policies and procedures, as well as code of ethics issues. In addition, a 2018 risk alert focused on common fee- and expense-related issues.

See "OCIE Risk Alert Warns of Six Most Frequent Fee and Expense Compliance Issues"

(May 3, 2018); and "Top Five Compliance Deficiencies in OCIE Risk Alert Include Annual Compliance Reviews, Accurate Regulatory Filings and Custody Issues" (Feb. 23, 2017).

Sources offered various reasons why the same kinds of issues appear to be perpetual problems or challenges for private fund managers.

"The wonderful thing about the private funds world is how dynamic it is. The challenging part of the compliance and legal effort is how dynamic it is. You're always reacting; things are always changing. The private funds business is very complex and does not show signs of simplification," Daly remarked. "It's not like the old days where you set up one fund and that's all you had to worry about. Now, managers have multiple funds, co-investors, different fee structures." He concluded, "It's an inherently conflicted situation. That's why a private placement memorandum (PPM) may have 20 pages of risk factors, many of which focus on conflicts."

"It's not that fund managers are trying to sneak in things. A decade ago, expense disclosures were very short and conceptual. They talked about categories rather than specific items. Look at a hedge fund that has been around for 15 years," continued Daly. "Look at a PE firm that launched European Buyout Fund One 15 years ago. If it launched European Buyout Fund Five last year, you would see a very, very different level of detail in the expense sections for those funds."

Osnato agreed, noting that "the impact of all of these cases and risk alerts has been to drive disclosure to very hyper-granular levels. Some advisers have received the message and enhanced their disclosures, but they may sometimes forget to abide day to day by the level of detail they put into their documents." "The SEC's disclosure expectations set through its enforcement actions led to a significant change in practice for drafting fund documents. Vague and often boilerplate language giving managers broad fee and expense authority was commonplace before Dodd-Frank's private fund manager registration requirements," Garver concurred. "Since then, we have seen expanding fee and expense provisions in response to the SEC enforcement actions. Instead of a paragraph, we're seeing pages – and not just in the PPM and the limited partnership agreement, but also in Form ADV."

See "A Roadmap of Potential Landmines for Fund Managers to Avoid When Completing the Revised Form ADV" (May 25, 2017).

In addition, Garver noted that "with the uptick in SEC enforcement, private fund managers and their attorneys are modifying their fund documentation and operations to address the risks that were present in those enforcement cases."

"Those remain persistent issues because they are not bright-line topics – they are challenging and complex areas and practices. When you peel away the layers, the private funds space is a very dynamic, evolving arena that is subject to innovation and changes in tools and technology," di Florio added. "Think about MNPI. We went from direct discussions with people involved in public companies to the birth of expert networks and the explosion of policies, procedures and controls around that. Now, managers are using alternative data but may not have extensive policies and procedures around that practice."

Compliance Is a Team Effort

Because of the complexity of being a private fund manager today, the burden of ensuring compliance with the myriad of rules and regulations cannot be borne solely by the compliance department or the CCO.

"If a manager is doing something differently in terms of the way it's conducting business – using different information to make decisions, thinking about a new strategy, allocating an expense differently or launching a new kind of fund – all of that needs to filter through compliance, legal and risk management," di Florio advised. "If there's going to be a change to a process or change to data used in that process, compliance needs to understand that change so it can determine whether there are any regulatory implications."

"CCOs must understand the business at a level that sometimes their colleagues on the investment management or fund finance side of the business may find surprising. They may ask the CCO, 'What are you doing in this meeting? There's nothing legal being discussed,'" Daly remarked. "You have to sometimes gently push back a bit. 'No, actually, I've got to understand what's going on to be able to surveil and supervise. I have to understand how we're doing things to make sure that our disclosures are correct.'"

"It's hard for fund documents and compliance programs to cover every possible scenario, especially as compliance should be tailored to the actual business. As things arise, your team has to be trained to identify when to alert compliance and work together to develop new policies. That's not always so simple," Garver noted. "Compliance also must be fully integrated to monitor and respond proactively." For example, "the finance function – the folks who actually make the allocations or the accounting entries – may believe in good faith that they're allocating things correctly and just miss the fact that a structure or a disclosure has changed and therefore they have to change the allocations," Osnato observed. "Managers must make sure that all parts of their business talk to one another and are not siloed."

Beware of Complacency

"CCOs can develop a false sense of comfort, but they must stay aware of how OCIE and the Private Funds Unit are digging deeper into nuances around particular issues and how the technology and tools that the SEC is using are always getting better and more sophisticated," di Florio cautioned. "What seemed perfectly reasonable three years ago can, through the evolution of those things, suddenly become an issue or deficiency. If you're not mindful to changes and don't deliberately update your technology, policies and procedures to reflect them, you're going to find people doing things that no longer comply."

See "How CCOs Can Use a Sample OCIE Information Request Letter to Improve Their Compliance Programs" (Jan. 28, 2020).

"For example, we have found situations where allocation processes are in place that haven't been rethought in some time – and maybe were never adequately thought through. They now run on autopilot," Daly added. "If you haven't thought about those processes in years, that is a signal that the industry may have moved past you and you may no longer be in the vanguard of the compliance and supervision effort anymore." He concluded that "compliance is a river; it doesn't stop moving. You've got to keep swimming."

What to Do Now

The Risk Alert "encourages 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 this Risk Alert." The sources who spoke to the Private Equity Law Report seconded that advice.

Review Compliance Program Against the Alert

"I would definitely use the Risk Alert as a checklist for review. Everyone has a lot going on right now – compliance especially has a Herculean task with everyone working remotely," observed Garver. "I would conduct a review soon, though, to, at the very least, show any soon-to-be-arriving examiner that you got the message and you're on it. It's not about being perfect. It is about taking the guidance and making sure you are doing everything you reasonably can do to comply."

"OCIE has highlighted the areas that it's concerned with, so you need to go through and make sure that you don't have any lingering issues in those specific areas. If you do, then you should address them and memorialize your review and the actions you have taken to remediate," Garver continued. "If in your review you don't detect any of the issues noted in the Risk Alert, it's still worth training the business team to make sure they're on the lookout for those issues if and when they do come up."

"The Risk Alert gives CCOs an opportunity to take a fresh look at all of those areas to make sure that their policies and procedures are tailored effectively to their businesses, strategies and funds as those have evolved," di Florio agreed. "They can then get a fresh round of communication and training out to their teams so everyone understands any changes and the expectations." He concluded, "Finally, they can ensure they're addressing these issues in their annual compliance reviews, mock exams, surveillance systems and testing programs so they're comfortable that what they say they're doing is actually happening."

The Focus for PE Fund Managers

"There is a significant amount of discussion in the Risk Alert around conflicts of interest that really go fundamentally to the PE business model: the conflicts associated with a GP-led restructuring; how fees and expenses flow between the manager and the portfolio companies; and the way staff are shared," di Florio remarked. "Given the importance of valuation for PE firms during this market disruption and dislocation, it's also going to be really important for PE CCOs to feel comfortable and confident about the compliance program around valuations and to make sure that it aligns well and complies with this alert."

"The disclosures and conflicts on the expense side are far more PE-focused than hedge fund focused – not entirely, of course, but they tend to skew more that way. The concept of operating partners also tends to be a PE concept more than a hedge fund concept," Daly observed. "So, a CCO for a PE fund manager should focus on those elements of the Risk Alert."

Timing of the Review

"The compliance effort is an ongoing process, and I don't think any CCO says, 'I'm going to make a note of this alert and I'll just wait for the annual review to see whether we're deficient,'" quipped Daly. "The time to see if

your disclosures are accurate is now. The time to check whether your expense allocations to clients and the fees you're charging them are accurate is now."

"CCOs are being stretched thin during the pandemic, but they should take the time now to review their programs in light of the Risk Alert. If you wait six months, that may be six months too late," Garver warned. "You may then be caught in an exam with deficiencies you could have easily remedied – and the examiners may be less sympathetic given their outreach."

Osnato also recommended conducting the review now. "Anecdotally, a lot of managers are doing it now. They're also having special trainings. There's zero upside to waiting if you think there's something you can improve now," he explained.

"The information is out there now. The expectation is going to be that you as a firm – as a CCO – had the opportunity to review the alert and digest it. Examiners will ask, 'What did you do with that information?'" commented di Florio. "A CCO wants to be able to say, 'We reviewed it when it came out. We formed a team internally, took this as a checklist and went through it to validate that we have coverage in each of these areas and that our policies and procedures are updated.'" He added, "Invariably, you're going to find systems, policies and procedures that were right at one point in time but haven't been updated. This is a great opportunity to close that gap."

In addition, the Risk Alert should be incorporated into the annual compliance review process. "Once a Risk Alert like this is out, CCOs are going to have to incorporate these three focuses into their annual compliance reviews," Daly noted.

As always, if a CCO makes any changes to the compliance program after a review – annual or otherwise – those changes need to be communicated to the appropriate employees and additional training needs to be provided, di Florio commented, adding that "if anything identified in the alert is missing from your monitoring and testing plan; systems; or data, you want to add that."

Use the Alert to Make the Business Case for Resources

"Anytime the SEC speaks, it's an opportunity for CCOs to go to their middle office, the finance function, the deal team and explain again that all of these areas continue to be priorities," Osnato advised. Daly added that a CCO should tell management that OCIE is "putting this alert out now because the staff thinks these are live issues for many advisers. Let's make sure we are not one of them."

"The technology tools and advanced data analytics capability the SEC has now enables it to find a lot more issues because they've got better expertise, tools and technologies. Fund managers need to be using the same tools and technology the regulators are using," di Florio explained. "Otherwise, they're at a real disadvantage. Firms are increasingly investing in these tools and technologies to help them catch up with regulators. But, a number don't, either due to budget constraints or because it's not a priority." He warned, "You don't want to be in a place where the SEC uses its tools to find compliance deficiencies that your tools didn't identify."

"Regulatory expectations evolve just like everything else. In the olden days, it was reasonable for regulators to expect CCOs to conduct random sampling, pull files

occasionally and look at how things were done," observed di Florio. "Today, because technology and analytics are easily available, the SEC's expectation is that firms are using those technology tools. So, firms that aren't doing that are in a tough spot."

"It's always hard for CCOs to make the business case for why they need technology and tools, but this Risk Alert helps them," concluded di Florio. He recommended that they take it to their leadership and say, "The SEC just came out with this list of common deficiencies. When they come to our firm, they're going to look for these things. They're going to bring their expertise, technology and analytic capability. If we don't have the same tools, it's going to be an uneven playing field."

See "How Fund Managers Can Use Technology to Enhance Their Compliance Programs" (Nov. 17, 2011).