August 18, 2020

SEC Issues Risk Alerts Outlining Various Compliance Risks and Issues Applicable to Investment Advisers

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The U.S. Securities and Exchange Commission's (the "***SEC***") Office of Compliance Inspections ("***OCIE***") recently issued two separate risk alerts describing certain compliance and regulatory risks, considerations, deficiencies and issues applicable to SEC-registered investment advisers ("***Advisers***") that have recently been observed or identified by OCIE.[1] In particular, these risk alerts highlight (i) various common compliance issues, considerations, issues and deficiencies relating to conflicts of interest, fees and expenses, and policies and procedures relating to material, non-public information, and (ii) select COVID-19-related compliance risks, considerations, observations and recommendations. Advisers are encouraged to carefully review and consider these risk alerts and their current practices, policies and procedures and take any necessary or appropriate steps or measures or actions to address the issues outlined therein.

June Risk Alert: Observations From Examinations of Advisers to Private Funds

On June 23, 2020, OCIE issued a risk alert setting forth various common compliance and regulatory risks, deficiencies, considerations and issues observed or identified by OCIE during recent examinations of Advisers to private funds (such risk alert referred to herein as, the "***June Risk Alert***").[2] The June Risk Alert categorized these observed deficiencies and compliance issues into the following three general categories: (1) conflicts of interest, (2) fees and expenses, and (3) policies and procedures relating to material, non-public information ("***MNPI***") and compliance with Rule 204A-1 under the Investment Advisers Act of 1940, as amended (the "***Advisers Act***"). These general categories are described in more detail below.

Conflicts of Interest

The first general category of compliance deficiencies outlined in the June Risk Alert relate to conflicts of interest, which continues to be a major focus area for the SEC. Pursuant to Section 206 of the Advisers Act, each Adviser has a fiduciary duty to eliminate, mitigate or disclose conflicts of interest with clients. In particular, an Adviser generally is required to eliminate, or make full and full disclosure regarding, conflicts of interest that may cause such Adviser to render advice to a client that is not disinterested. To this end, such disclosure must be sufficiently specific so that a client or investor is able to understand the material facts or conflicts of interest and make an informed decision whether or not to consent thereto. In the June Risk Alert, OCIE highlighted various situations or circumstances in which Advisers to private funds either failed to appropriately mitigate or address or failed to adequately disclose conflicts of interest relating to:

- *The allocation of investment opportunities between or among applicable clients.*
    - OCIE observed that certain Advisers to private funds failed to provide adequate disclosures regarding their investment opportunity allocation practices and conflicts related thereto (including

[1] *See* SEC Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020), https://www.sec.gov/ocie/announcement/risk-alert-private-funds; SEC Risk Alert, "Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers" (August 12, 2020), https://www.sec.gov/ocie/accouncement/risk-alert-covid19-compliance.

[2] SEC Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds" (June 23, 2020), https://www.sec.gov/ocie/announcement/risk-alert-private-funds.

how Advisers allocate investments or co-investments between or among applicable private funds, separately managed accounts and other clients). For example, certain Advisers to private funds did not provide adequate disclosure regarding preferential allocations given to certain clients or types of clients (such as preferentially allocating investments to higher-fee paying clients).

- *Multiple clients investing in the same portfolio company*.
    - Certain Advisers to private equity funds did not provide adequate disclosure about the conflicts created by causing clients to invest at different levels of a capital structure, such as one client owning debt and another client owning equity in a single portfolio company.
- *Financial, economic or other relationships between investors or clients and the Adviser or its affiliates or employees*.
    - Many Advisers to private funds did not provide adequate disclosure of conflicts relating to economic, financial or other relationships between such Advisers and select investors and/or clients (such as "seed" or "founder" investors or clients).
- *Preferential liquidity rights*.
    - Certain Advisers to private funds failed to adequately or appropriately disclose preferential liquidity or withdrawal rights provided or granted to select investors and/or clients pursuant to side letters and similar agreements and separately managed accounts entered into between such advisers and such investors and/or clients.
- *Financial, economic and other interests of Advisers and/or their employees or affiliates in investments.*
    - OCIE observed that certain Advisers to private funds failed to properly disclose pre-existing ownership or other financial or economic interests in companies, securities or investments recommended by such Advisers to their clients (or investments made by Advisers on behalf of their clients).
- *Co-investors and the allocation of co-investment opportunities.*
    - OCIE identified certain Advisers to private funds that inadequately disclosed conflicts relating to investments made by co-investment vehicles and other applicable co-investors. For example, Advisers failed to follow their disclosed practices or processes regarding the allocation of co-investment opportunities among investors and clients, and Advisers also did not provide adequate disclosure relating to the preferential allocation of co-investment opportunities to certain investors and/or clients pursuant to side letters or similar agreements or arrangements and/or separately managed accounts entered into between such Advisers and such investors and/or clients.
- *Relationships between service providers and Advisers (or affiliates thereof)*.
    - Certain Advisers to private funds caused portfolio companies owned and controlled by one or more of their private fund clients to enter into service agreements or arrangements with companies directly or indirectly controlled by, or affiliated with, such Advisers and/or affiliates thereof (including family members of principals of such Advisers) without adequately disclosing

the conflicts (or seeking and obtaining client or investor consent). In addition, certain Advisers did not provide adequate disclosure regarding the material conflicts applicable in connection with the selection and retention of service providers for or on behalf of their affiliated private funds and other clients (including financial or other incentives of Advisers to cause their clients to engage or retain certain service providers).

- *Fund restructurings*.
    - OCIE observed that certain Advisers inadequately disclosed conflicts relating to restructurings of their private fund clients. For example, Advisers or affiliates thereof purchased or acquired interests in their private fund clients from investors in such funds at discounts during restructurings without adequate disclosures or Advisers failed to provide investors with adequate disclosures regarding their options in restructurings of their private fund clients.
- *Cross-transactions involving the purchase or sale of investments between or among multiple clients of an Adviser.*
    - OCIE identified and observed certain Advisers that inadequately disclosed conflicts related to purchases and sales of investments or other transactions between or among multiple clients, or cross-transactions (especially with respect to pricing and cost).

Fees and Expenses

The second general area of deficiencies noted in the June Risk Alert relates to fee and expense issues and disclosures, which, like conflicts of interest, continue to be a major focus area of the SEC. OCIE provided specific examples of circumstances where inadequate, incomplete or insufficient fee and expense disclosures or other issues may give rise to or be deemed to result in violations of Section 206 and Rule 206(4)-8 under the Advisers Act, including, without limitation, the following: (i) the allocation of fees and expenses in a manner inconsistent with disclosures to investors and clients, (ii) inadequate disclosure regarding the roles and compensation of non-employees of the adviser (also known as "operating partners") who provide services to one or more private fund clients and/or portfolio companies owned by such private fund clients, (iii) failure to follow disclosed valuation processes and procedures with respect to assets in client accounts, and (iv) inadequate disclosure regarding the receipt of transaction fees by Advisers and their employees and affiliates from portfolio companies and affiliates thereof, such as board fees, monitoring fees or deal fees, or the failure by Advisers to apply or properly apply or calculate applicable management fee offsets in accordance with the disclosures provided to applicable investors and clients (including incorrect allocations of such transaction fees across such clients).[3]

[3] In recent years, the SEC has brought a number of enforcement proceedings against Advisers for violations relating to fees and expenses. See, e.g.*, In re Rialto Capital Management, LLC,* Investment Advisers Act Release No. 5558 (August 7, 2020); *In re Yucalpa Master Manager, LLC*, Investment Advisers Act Release No. 5074 (Dec. 13, 2018); *In re Lightyear Capital LLC*, Investment Advisers Act Release No. 5096 (Dec. 26, 2018); *In re First Reserve Management, L.P.*, Investment Advisers Act Release No. 4529 (Sept. 14, 2016); *In re Kohlberg Kravis Roberts & Co. L.P.*, Investment Advisers Act Release No. 4131 (June 29, 2015). Compliance issues relating to the allocation of fees and expenses (and disclosures relating thereto) continue to be one of the most common items identified or observed by OCIE during examinations of Advisers to private funds.

MNPI and Code of Ethics

The final general category of deficiencies and compliance issues outlined in the June Risk Alert relates to Section 204A of the Advisers Act and Rule 204A-1 promulgated thereunder (and the policies and procedures required to be adopted by Advisers pursuant thereto). Section 204A of the Advisers Act requires Advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by Advisers and their associated persons. Rule 204A-1 under the Advisers Act requires all Advisers to adopt and maintain a code of ethics, which includes procedures and policies addressing the conduct and personal trading activity of their supervised persons. As noted in the June Risk Letter, OCIE observed various deficiencies and compliance issues relating to Section 204A and Rule 204A-1 under the Advisers Act including, without limitation, the following:

- First, Advisers failed to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI in accordance with Section 204A of the Advisers Act, including risks posed by supervised persons interacting with (i) insiders of publicly traded companies, (ii) "expert network" firms, (iii) "value added investors" (corporate executives or financial professionals with information about investments), and/or (iv) private investments in public equity (PIPEs).

- Second, Advisers did not establish, maintain and enforce provisions in their code of ethics that are reasonably designed to prevent or detect the misuse of MNPI by their supervised persons. OCIE cited a number of specific examples of the foregoing in the June Risk Alert, including, without limitation, the following: (i) Advisers failed to enforce trading restrictions applicable to their supervised persons on securities or issuers placed on the "restricted list", (ii) Advisers did not enforce requirements in their code of ethics relating to employees' receipt of gifts and entertainment from third parties, and (iii) Advisers did not implement or enforce provisions in their code of ethics requiring (A) the timely identification of personnel or agents as "access persons," (B) pre-clearance for certain proposed personal securities transactions by access persons, as and to the extent required by the code of ethics or Rule 204A-1 under the Advisers Act, and (C) timely submission of quarterly transaction and holdings reports by access persons.

AUGUST RISK ALERT: SELECT COVID-19 COMPLIANCE RISKS AND ISSUES

Advisers and other SEC-registrants have been faced with significant new operational, technological, commercial, business and other challenges and issues in response to the COVID-19 global pandemic and public and private sector responses to COVID-19, which have in many cases created important regulatory and compliance questions and considerations for Advisers and other registrants. On August 12, 2020, OCIE issued a risk alert outlining its observations and recommendations with respect to select COVID-19-related issues, risks and practices relevant to Advisers and broker-dealers (the "***August Risk Alert***" and, together with the June Risk Alert, the "***Risk Alerts***").[4] The August Risk Alert broadly categorizes or groups these COVID-19-related recommendations and observations into the following six categories:

- *Protection of Investor Assets*. Each Adviser has a duty to ensure the safety of client and investor assets and to guard against theft, loss and misappropriation. In light of the current environment and the impacts of the COVID-19 pandemic, Advisers and other SEC-registrants should review their current policies and procedures regarding protection of client and investor assets and make appropriate adjustments or

[4] SEC Risk Alert, "Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers" (August 12, 2020), https://www.sec.gov/ocie/accouncement/risk-alert-covid19-compliance.

modifications. For example, Advisers should review their current practices and procedures regarding the processing of transfer, withdrawal, redemption or disbursement requests or instructions from clients and investors and make appropriate adjustments or modifications to address or mitigate COVID-19-related risks and considerations.

- *Supervision of Personnel.* Advisers and other SEC-registrants have made significant changes and modifications to their business practices, procedures and operations in order to respond to the health, economic and other effects or consequences of the COVID-19 pandemic, including shifting all or a portion of their employees to remote work arrangements. As a result of the foregoing, Advisers should closely review their supervisory and compliance policies and procedures and make any appropriate modifications, changes or amendments. For example, Advisers should modify their practices in an attempt to address supervisors not having the same level of oversight and interaction with supervised persons when they are working remotely.

- *Fees, Expenses and Financial Transactions*. OCIE noted that the recent market volatility and resulting impact on client assets and the related fees collected by Advisers may increase the financial pressures on Advisers and their personnel to compensate for lost revenue. In light of the incentives, risks and other issues raised or caused by the recent COVID-19 pandemic and the consequences thereof, Advisers should review their fee and expense policies and procedures and consider enhancements to their compliance monitoring, as described in more detail in the August Risk Alert.

- *Investment Fraud*. OCIE cautioned Advisers to be cognizant of the heightened risks of investment fraud when conducting due diligence on investments and in determining whether investments are in the best interest of their clients.

- *Business Continuity*. Due to the COVID-19 pandemic, many Advisers have shifted to predominately operating from remote sites (such as moving all or a portion of their employees to remote working arrangements), and these and other transitions may raise compliance issues and other risks related to business continuity. As a result, Advisers should carefully review their business continuity policy and other similar policies and procedures to ensure that they are reasonably designed to address these material compliance issues and risks, make any appropriate adjustments, changes, additions or modifications to such business continuity plans and other compliance policies and procedures, and provide disclosures to their investors and clients if their operations are materially impacted, as appropriate.

- *Protection of Sensitive Information*. As a result of the COVID-19 pandemic and the consequences thereof, Advisers and their personnel have been increasingly reliant upon videoconferencing and other electronic means to communicate with investors, clients and others while working remotely. While necessary, OCIE noted that these electronic communication methods and similar practices create (i) vulnerabilities around the potential loss of sensitive information, including personally identifiable information, and (ii) more opportunities for fraudsters to use phishing and other means to improperly access systems and accounts by impersonating Adviser personnel and/or investors and clients. Advisers should carefully review their policies, procedures and practices relating to privacy and protection of investor and client information (including data protection, information security and cybersecurity) and consider whether any changes, amendments or adjustments are appropriate, necessary or advisable in light of the increased use of electronic communication methods by their personnel.

Advisers should carefully review the August Risk Alert, OCIE's recommendations and observations set forth therein and their internal practices, policies and procedures (including applicable compliance policies and procedures), consider whether any changes, adjustments or modifications are necessary, advisable or appropriate in light of the recommendations set forth in the August Risk Alert and make any appropriate changes, adjustments or modifications to their policies, practices and procedures.

CONCLUSION

The Risk Alerts provide Advisers and other SEC-registrants with the opportunity to review their internal policies, practices and procedures and to determine whether any changes, adjustments or modifications are necessary, advisable or appropriate in order to address or resolve the items, observations, recommendations or issues described by OCIE therein. One of the main goals of OCIE in publishing the Risk Alerts is to provide notice to Advisers and other SEC-registrants of important compliance and regulatory issues, risks and considerations that have been identified or observed by OCIE so that Advisers and other SEC-registrants can take any necessary or appropriate steps to resolve or address such issues and risks prior to any future OCIE examinations. The Risk Alerts should serve as a warning to all Advisers that OCIE may be more willing to take action (including enforcement proceedings) against Advisers in the event that these issues, risks and deficiencies are identified or uncovered by OCIE in future examinations.

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For more information, please contact one of the following Haynes and Boone lawyers:

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