

> Client Alert

OCIE Examinations of Private Fund Advisers Highlight Deficiencies that Expose Investors to Undisclosed Risks

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If you would like any further information concerning the risk areas recently highlighted by OCIE and any potential compliance issues, please feel free to contact

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Recent guidance from the Office of Compliance Inspections and Examinations warns investment advisers that inadequate disclosures and failures to adhere to policies and procedures may cause investors to overpay fees and expenses and to fail to understand fully critical aspects of how the investment adviser is managing their capital.

OCIE identified three general areas of deficiencies – inadequate disclosure relating to conflicts of interest, calculation and payment of fees and expenses, and policies and procedures relating to material non-public information that were of particular concern.

Conflicts of Interest. Although the SEC has yet to fully explain what specifically constitutes adequate disclosure, in its examination of the treatments of conflicts of interest, OCIE identified certain practices which clearly fell short of being adequate. For example, the OCIE cautioned that disclosure regarding allocation of investment opportunities among advisers with multiple clients (including co-investment vehicles and separately managed accounts) often fell short of explaining to investors that limited investment opportunities could be preferentially allocated to certain types of investors, to the detriment of other investors. OCIE also highlighted the importance of sufficient disclosure to all investors of the myriad risks and benefits for different clients invested in different levels of a company's capital structure, the different economic characteristics of seed arrangements in pooled investment vehicles, as well as interests seed investors might have directly in the adviser, and preferential liquidity and other terms granted to certain investors through side letters. OCIE noted that certain advisers failed to adequately inform investors when affiliates of the adviser performed services for an adviser's client and that these arrangements often failed to provide the details of such arrangement being adequately disclosed to a fund's investors. Additionally, OCIE observed investment advisers failing to actually follow the investment allocation procedures disclosed to investors.

Fees and Expenses. Understandably, OCIE remains concerned about investors overpaying fees and expenses and noted that even when the disclosure was not by itself inadequate, an investment adviser's failure to follow the policies contained in the disclosure constituted a violation of the Advisers Act, particularly when allocating broken-deal and due diligence costs among the adviser's clients and reimbursing transactions with operating partners. Investment advisers should also pay particular attention to their policies concerning valuation, monitoring fees, travel and entertainment and expense reimbursement and make sure that their practice reflects their policies.

MNPI / Code of Ethics. Although private fund advisers are required to establish, maintain and enforce written policies and procedures designed to prevent the misuse of material non-public information, OCIE noted that certain advisors did not address the risks from their employees' interactions with "expert network" firms or shared office space. Even if developed, policies and procedures were also sometimes

not properly followed. For example, certain advisers did not enforce trading restrictions on securities that had been placed on an adviser's "restricted list" or requirements pertaining to employees' receipt of gifts and entertainment from third parties.

While not articulating any new perspectives, by identifying areas of concerns that it has uncovered during examinations, OCIE is emphasizing that if investment advisers want to avoid deficiency letters or enforcement actions, they should continuously review and update their disclosure and policies and procedures to make sure that investors are receiving the full breadth of information that they need to make informed investment decisions and that further is cautioning investment advisers to strictly abide by such disclosures so that investors are treated fairly and consistent with an investment adviser's fiduciary duty.