

# Private Funds and the Clayton SEC: Out From Under the Microscope?

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Nearly a decade ago, managers of hedge funds and private equity funds faced a rude awakening when, in the wake of Dodd-Frank's 2010 passage, they found themselves governed by vastly expanded SEC oversight. Private investment funds joined the ranks of advisers to individual retail client accounts and mutual funds, subjected to periodic exams by the SEC's Office of Compliance Inspections and Examinations (OCIE) and targeted by the growing scrutiny of the SEC's Division of Enforcement. After years of limited SEC attention (aside from cases of outright fraud and misappropriation), fund managers had to learn to respond to protracted, resource-intensive examinations, and in many cases investigations (and potential enforcement actions) aimed at fee and expense practices common to the industry.

The following years saw the SEC quickly ramp up its oversight of these newly-registered funds. OCIE introduced its "Presence Exam" program, designed to allow the SEC staff to quickly visit a large number of new registrants by conducting more abbreviated examinations focused on specific high-risk areas such as marketing materials, portfolio management procedures, and asset custody. The increase in the volume of private fund exams unsurprisingly resulted in a number of enforcement referrals, with the Enforcement Division filing multiple actions against hedge fund and private equity fund managers on topics such as expense allocations, conflict of interest disclosures, and asset valuation.

However, the new SEC administration under Chairman Jay Clayton has signaled that its priorities lay elsewhere. In speech after speech, Clayton and other SEC officials, including the OCIE and Enforcement leadership, have emphasized their focus on "retail" investors, particularly retirees and mom-and-pop investors unlikely to be placing their retirement funds (at least directly) into riskier private funds. But does this mean that private fund managers are off the hook?

Alas, it is a little too soon for these investment advisers to kick back and relax. Dodd-Frank's registration requirements remain intact; OCIE's expanded infrastructure overseeing private funds is not going away any time soon; and Enforcement continues to demonstrate an interest in pursuing cases against fund managers.

## Examinations of Hedge Funds and Private Equity Funds

In July 2017, in his first speech as Chairman, Jay Clayton declared his acute interest in “the long-term interests of the Main Street investor. Or, as I say when I walk the halls of the agency, how does what we propose to do affect the long-term interests of Mr. and Ms. 401(k)?”<sup>1</sup> A few weeks later, the Director of OCIE echoed these comments, noting that, while private equity funds would still be subject to oversight, “we are going to focus more on retail investors.”<sup>2</sup>

The 2018 exam priorities shared by OCIE in a February 2018 publication confirm that the investment adviser exam program will be focused primarily on matters impacting individual retail investors.<sup>3</sup> The bulk of the OCIE release comes under the header “Retail Investors, Including Seniors

the hook. OCIE’s exam priorities, while addressing various fee and expense practices, specifically note that the program will target, among others, “private fund advisers that manage funds with a high concentration of investors investing for the benefit of retail clients, including non-profit organizations and pension plans.” In other words, private funds with sophisticated, well-heeled institutional investors are still retail advisers in the eyes of the SEC.

The SEC’s ongoing interest in private funds is also necessitated by legislative and practical realities. Dodd-Frank mandated registration for many private funds, and notwithstanding some post-election moves by Republicans to roll back Dodd-Frank, it seems unlikely that the House and Senate will align on repealing the fund registration requirements. Until that happens, the SEC remains obligated to oversee the private funds registered with the agency (and subject to SEC examinations), and risks significant political exposure if a registered fund manager turns out to be the next Madoff or Stanford.

Moreover, the SEC has significantly built the ranks of its investment adviser exam staff, including specialists in the private fund industry. Since Dodd-Frank’s passage, OCIE went on something of a hiring binge, expanding from about 820 full-time equivalent positions in FY 2012 to 1063 in FY 2017.<sup>4</sup> A significant portion of these hires went into the group’s investment adviser program; additionally, in 2016, OCIE shifted about 100 broker-dealer examiners (whose work is often duplicative of exams performed by FINRA) into the investment adviser side of the office.<sup>5</sup> While the federal hiring freeze imposed under the Trump administration has reduced the size of the SEC through normal attrition, the SEC’s 2019 budget request seeks to restore a number of lost positions, including investment adviser examiners.<sup>6</sup>

And beyond mere numbers, OCIE has responded to the changing nature of the post-Dodd-Frank registrant pool by building its private funds expertise, including hiring examiners with industry experience and, in 2015, establishing a specialized Private Funds Unit dedicated to examining fund advisers.<sup>7</sup>

In short, for all the attention being paid to retail investment advisers, the SEC is not about to curtail its examinations of private equity and hedge fund managers. And while the exam priorities do not provide significant guidance, certain key themes emerge both from OCIE publications and recent exam experience.

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and Those Saving for Retirement,” emphasizing subjects such as the disclosure of investment costs, wrap fee programs, retirement accounts, and mutual fund and ETF performance.

Yet the SEC’s repeated invocations of seniors and retail investing do not leave private funds off

First, as noted above, the disclosure of the costs of investing is a key element for investment adviser exams. As set forth in the priorities release, the SEC is focused on “whether fees and expenses are calculated in accordance with the disclosures provided to investors.” The SEC expanded on its concerns in an April 2018 Risk Alert highlighting some of the most frequent advisory fee issues identified in its exams.<sup>8</sup> The Risk Alert specifically referenced, in connection with exams of private fund advisers, misallocation of various expenses to the fund rather than the adviser, in contravention of the Limited Partnership Agreement or other applicable documents.

The allocation of expenses across multiple funds, the fund manager, and (in the case of private equity funds) portfolio companies invariably receives significant attention from examiners during fund exams. (And as discussed below, such allocations are often the subject of enforcement actions as well.) Indeed, at a recent industry conference, half of all attendees who had been examined by the SEC reported that they received comments on fee or expense allocations.<sup>9</sup>

While the remainder of the advisory fee Risk Alert addressed matters affecting investment advisers generally, some items are no less applicable to private fund managers, including:

- Advisory fees based on incorrect valuations
- Billing fees in advance or with improper frequency
- Fee and expense practices inconsistent with Form ADV disclosures

Another recent OCIE Risk Alert identified recurring exam deficiencies relating to advertising.<sup>10</sup> As with the fee-related Risk Alert, much of the OCIE publication is directed at retail advisers; yet, again, some lessons shine through for fund managers. Most notable is the SEC’s admonition about misleading performance results, including the failure to deduct advisory fees, the use of benchmark comparisons without adequate disclosures about the limitations of such comparisons, and advertisements with hypothetical or backtested results without adequate explanation and disclosures. More generally, the Alert noted deficiencies in policies and procedures around the review and approval of advertising materials.

Though not detailed in the Alert, other advertising issues that tend to draw comments in fund exams include, among others:

- Cherry-picking high-performing portfolio holdings rather than using objective, non-performance based criteria
- Target returns lacking an adequate basis
- Inadequate records supporting performance data
- Inappropriate attribution of track record to current portfolio managers

Another perennial focus area for the SEC exam staff is the handling and disclosure of conflicts of interest. While OCIE’s annual exam priorities do not typically highlight conflicts, the topic is consistently explored in depth in exams of private fund managers. Examiners tend to seek detailed information on services provided by affiliated persons and entities, exploring any personal or business relationships which in the view of the staff may influence the manager’s decisions. Exams also focus on whether certain investors stood to receive beneficial treatment.

Even for remote conflicts, examiners will inquire into the existence and disclosure of potential conflicts and whether steps taken to disclose and mitigate such conflicts were consistent with the firm’s internal policies, LPAs and other operative agreements, and fiduciary duties generally.

Conflicts scrutinized by the SEC include:

- Payments to affiliated service providers by the management company or a portfolio company
- Allocation of investment opportunities among funds
- Allocation of co-investment opportunities to preferred investors or affiliates

While fee and expense practices, advertising, and conflicts of interest may dominate examiner interest, OCIE continues to probe other areas in most private fund exams. Cybersecurity, unsurprisingly, remains of keen interest. As set forth in the 2018 exam priorities, exams will continue to probe advisers’ risk assessment, controls, training, and incident response. (An August 2017 Risk Alert highlights findings from a targeted exam of registrant cybersecurity preparedness, providing more detailed guidance on issues identified by SEC examiners.<sup>11</sup>) Private fund manager exams also continue to review advisers’ compliance with the custody rule, implementation of compliance programs specifically tailored to the registrant’s business and risks, and maintenance of books and records. And, more recently, examiners have begun inquiring into any investments by fund managers in cryptocurrency and initial coin offerings.

Finally, the SEC's 2018 exam priorities, as in past years, reference OCIE's ongoing commitment to examining registered investment advisers that have never been examined, ensuring that private fund managers who have yet to undergo an exam (or have not done so in many years) will remain on the agency's radar screen.

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### Enforcement Actions

Though not receiving the same fanfare as just a few years ago, enforcement actions against private fund managers continue to be a meaningful component of the Enforcement Division docket. For example, in late 2017, the SEC brought two cases relating to private equity fund fee and expense disclosures. In September, the SEC brought a settled action against a private equity fund adviser for charging broken deal expenses to the funds it managed.<sup>12</sup> According to the SEC, while certain co-investors participated in the profits from successful transactions, the firm (which did not admit the allegations) did not allocate expenses for un consummated deals to the co-investors, and failed to disclose this practice to investors in the funds.

Similarly, in December, the SEC brought a settled action against an adviser for allegedly charging accelerated monitoring fees upon exiting from portfolio company investments without adequate disclosure of the practice.<sup>13</sup> According to the SEC, while the firm disclosed that it would charge the portfolio companies monitoring fees, and reported the actual amount of fees collected, the fund

agreements did not give investors advance notice that it would accelerate monitoring fees before they committed capital to the fund.

Interestingly, the SEC's public announcement of these cases was relatively muted. When the SEC instituted comparable cases involving broken deal expenses and accelerated monitoring fees in 2015, the filings were accompanied by press releases trumpeting the charges and the significant penalties assessed by the SEC, with proclamations from the SEC's then-Director of Enforcement admonishing the firms.<sup>14</sup> In contrast, the 2017 actions received far less attention, neither accompanied by press releases with Enforcement commentary. It remains unclear whether this was intended to convey a subtle message that the SEC was less enthusiastic about such cases in the new administration; or simply a recognition that the second broken deal expense case or accelerated monitoring fee case was less newsworthy than the first.

Conflicts of interest also remain a recurring theme for SEC enforcement actions. In an April 2018 settled action, the SEC alleged that a New York-based private equity fund manager failed to disclose conflicts of interest surrounding its receipt of compensation from a company that provided services to portfolio companies owned by the private equity funds managed by the adviser.<sup>15</sup> According to the SEC, the service provider, which specialized in aggregating companies' spending to obtain volume discounts from participating vendors, compensated the investment adviser based on a share of the fees it received from vendors as a result of the adviser's portfolio companies' purchases through it, such as office supplies and car rentals.

In a pair of back-to-back cases in May, the Division of Enforcement signaled its ongoing scrutiny of asset valuation, as well as its focus on advisers' monitoring of insider trading and performance advertising. In the first case, a New York-based investment adviser to two private funds settled claims that two of its former portfolio managers engaged in an asset mismarking scheme, and its chief financial officer agreed to a one-year bar from the securities industry for allegedly failing to supervise those two individuals.<sup>16</sup> The SEC claimed that the two portfolio managers employed by the adviser falsely inflated the value of securities held by hedge funds it advised, causing the funds to falsely inflate returns, overstate their net asset value, and pay excess fees to the adviser. Moreover, the SEC also claimed that certain portfolio managers engaged in insider trading in the securities of pharmaceutical

companies and home healthcare providers.

The following day, the SEC charged a New York-based hedge fund adviser with inflating by hundreds of millions of dollars the value of private funds it advised, in order to conceal poor fund performance and attract and retain investors.<sup>17</sup> The SEC also charged the adviser's chief executive officer and chief investment officer, as well as three former employees (a former partner, a former portfolio manager, and a former trader, all of whom are under criminal investigation).

These recent cases reflect the SEC's publicly-stated enforcement priorities relevant to private funds. In April, staff from the Enforcement Division's Asset Management Unit (AMU), along with staff from other divisions, gathered to discuss issues facing compliance personnel at the SEC's 2018 Compliance Outreach seminar.<sup>18</sup> The staff outlined several of AMU's priorities applicable to private funds, particularly the disclosure of conflicts of interest regarding fees, compensation that advisers receive from broker-dealers, and transactions that benefit advisers' affiliates. The staff highlighted its interest in fees and expenses assessed contrary to a fund's investor disclosures, and the allocation to funds of expenses more appropriately borne by the management company. Additionally, the staff explained that, in its charging decisions, the Enforcement Division would take into account the duration and magnitude of problematic fees, with the likelihood of filing an enforcement action increasing if a particular undisclosed fee was lucrative for the manager and a client was charged for an extended period of time.

## Staying Prepared for Ongoing SEC Scrutiny

While the SEC's public statements may suggest that the heightened scrutiny of private fund managers in the years following Dodd-Frank may have eased somewhat under the new administration, there is no question that these advisers will continue to be subject to probing exams by a beefed-up examination staff and the risk of enforcement actions where their disclosures and practices fail to measure up to SEC expectations. Hence, it remains essential for registered advisers to be prepared. The following pointers should be in the toolkit of the principals and compliance professionals of registered fund advisers.

- Registered advisers who have never been examined, or who have to date only been subjected to a brief "presence" exam by the SEC staff after initially registering, should assume that it is just a matter of time before they get a call from the SEC. Similarly, advisers who have more recently undergone an exam that uncovered significant deficiencies should expect a follow-up visit from the staff to ascertain whether such matters have been fully remediated.
- Advisers who have not yet undergone a standard SEC examination should consider retaining a consultant to provide a "mock exam." These procedures can be helpful in identifying deficiencies that the firm's compliance staff and legal counsel may not pick up on their own. They can also help the firm assess potential weaknesses in the adviser's ability to respond effectively when the real staff shows up on their doorstep—particularly the firm's ability to expeditiously locate and collect documents typically requested by the examiner, and the comfort level of firm management and personnel in responding to the sort of interview questions they may be asked during an on-site examination.
- Relatedly, compliance personnel should review their document retention and organization practices. SEC exams are initiated with a document request that can be astounding in its breadth for advisers who have not previously been through the process; and the staff typically expects documents to be provided in short order, often just a week or two. Even more focused exams targeting a particular adviser practice will include significant demands for documents. Firms, either with a compliance consultant or on their own, should review a sample examination document request to determine whether they would be prepared to respond on a timely basis.
- More broadly, fund managers should review their fee and expense disclosures. Similarly, they should review their disclosures regarding any services provided by affiliates (or other potential conflicts, such as allocation of investment opportunities and expenses across funds). Are the disclosures clear? Are they consistent with the firm's actual practices? Have potential conflicts been handled in accordance with any procedures set forth in the fund's offering documents (such as review by an advisory committee)? To the extent the firm identifies fee or expense payments which appear to be contrary to their disclosures to investors, or detects potential conflicts that have

not been adequately disclosed or escalated, management should consider whether some remediation might be in order. Examiners identifying expenses they believe to have been improperly allocated to investors will typically push the adviser to refund such charges to the fund; proactively remediating such charges even before the examination can mitigate the risk of an OCIE deficiency letter and, more significantly, make the matter far less attractive to the Enforcement Division. Sitting back and hoping that an SEC examiner does not discover the issue is rarely the best approach.

- Get your cybersecurity house in order! Data security is of paramount interest to both the exam and enforcement programs. Even beyond the risk of SEC action, a data breach comes with tremendous financial and reputational costs.
- Finally, while compliance personnel need to focus on the SEC priorities discussed above, they can't ignore the little things. OCIE's public reports on the findings arising out of its exam program don't always align with the agency's top priorities, and give valuable insight into what OCIE continues to look for (and find) in its investment adviser exams. For example, a February 2017 OCIE risk report identified the five most frequent compliance failures found in recent investment adviser exams, including compliance policy shortcomings, inaccurate Form ADVs, Custody Rule violations, and books and records deficiencies.<sup>19</sup> While these types of deficiencies may be less likely to result in enforcement referrals (absent repeat offenses), they can add up and lead the exam staff to view the registrant as higher risk, drawing more frequent and more in-depth examinations.

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