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PRIVATE FUNDS: PREPARING FOR ANOTHER YEAR IN THE SEC CROSSHAIRS

In 2014, the SEC's investment adviser examiners focused on private funds, newly required to register by the Dodd-Frank Act. The staff's exam priorities included fees and expenses, marketing and valuation, compliance and custody, and, to a lesser extent, insider trading. The authors discuss these examinations and related enforcement actions. They conclude with the steps needed to prepare for a visit as the Commission's emphasis on private funds continues into 2015.

By Marc J. Fagel and Leslie A. Wulff *

The Securities and Exchange Commission's stepped-up focus on private fund managers throttled into high gear in 2014, as the SEC's Office of Compliance Inspections and Examinations ("OCIE") began sharing its findings emerging out of its initial examinations of hedge funds and private funds newly registered under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). These exams have been augmented by the aggressive stance of the SEC's Enforcement Division, which filed a number of high-profile enforcement actions against private funds. Cases against investment advisers generally remain one of the largest components of the SEC's enforcement docket (far outstripping public company accounting fraud and insider trading cases).

As we begin 2015, this phenomenon shows no sign of slowing down. In a public statement issued on the fourth anniversary of Dodd-Frank, SEC Chair Mary Jo White highlighted private fund advisers as one of the SEC's ongoing priorities.[1] OCIE Director Andrew Bowden noted that, since October 2012, OCIE has conducted focused "presence examinations" of over 370 newly registered fund advisers and is on track to meet its goal of examining a quarter of all new registrants by the end of 2014.[2] And Enforcement Director Andrew

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[1] Mary Jo White, SEC Chair, Statement on the Anniversary of the Dodd-Frank Act (July 17, 2014), *available at* www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542321653.

[2] ACA Compliance Group, *SEC Focus on Private Fund Performance and Marketing* (Oct. 2, 2014), *available at*

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Ceresney has emphasized that private funds remain on the list of the Enforcement Division's targeted areas of focus for 2015.[3]

For fund managers long accustomed to operating with minimal regulatory oversight, the intensive SEC scrutiny, coupled with the threat of a potential enforcement action if the firm's practices and disclosures fail to measure up to the SEC's exacting standards, has been a sometimes harsh introduction to the atmosphere in which brokers and mutual funds have historically endured. Fortunately, OCIE's multiple public pronouncements, periodically backed by forceful actions from Enforcement, provide meaningful guidance to fund advisers on the SEC's priorities in the months ahead.

As discussed below, some of the hottest topics arising out of OCIE's presence exams, and the issues most likely to garner future Enforcement interest, include expense allocation and undisclosed fees, asset valuation, and misleading marketing materials. In addition, recurring issues continue to arise out of the custody rule, inadequate (or unenforced) compliance policies, and insider trading.

Fees and Expenses

In a highly publicized speech in May 2014, Bowden explained that OCIE is particularly focused on the issues of improper expense allocation and inadequately disclosed fees.[4] Addressing private equity in particular, Bowden stated that OCIE found violations of the law or material weaknesses with regard to fees and expenses in over 50% of the 150 private equity examinations conducted to date. Specifically, Bowden expressed concern with instances of consultants' salaries and expenses being allocated to the fund, rather than to firm overhead, especially when those "consultants" look and act like fund employees.

More generally, practitioners in the field have observed OCIE raising numerous questions about the manner in which private fund managers allocate expenses among the adviser, one or more funds managed by the firm, and, in the case of private equity funds in particular, portfolio companies held by the fund. Everything from legal and audit expenses, marketing expenses, research, and various administrative expenses may be called into question if the adviser lacks sufficient procedures and documentation to support its allocation determinations, and if those allocations are deemed inconsistent with the fund's disclosures in its partnership agreements, offering documents, and other marketing materials. Private equity funds face additional issues, including their allocation of due diligence expenses, including costs associated with broken deals.

OCIE has similarly been scrutinizing fee disclosures, particularly for funds which may charge multiple fees, including both the management fee based on assets under management, as well as monitoring, transaction, and various success fees targeted to the performance of the underlying investments or portfolio companies. Again, Bowden specifically singled out private equity funds for their fee practices. Among other things, he questioned the practice among some funds of accelerating monitoring fees in order to assess fees from portfolio companies for periods extending beyond the anticipated term of the fund.

The SEC drove home its point about the importance of proper fee and expense practices in several 2014

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www.acacompliancegroup.com/news/compliance-alert/sec-focus-private-fund-performance-and-marketing. As initially conceived and explained by OCIE, the SEC would attempt to maximize its coverage of new registrants by conducting "presence exams," which it suggested would be more focused and abbreviated than traditional exams of investment advisers. But even these "presence exams" are significantly resource-intensive, and whether they are truly streamlined is open to debate.

[3] J. Eaglesham, *As SEC Enforcement Cases Rise, Big Actions Are Sparse*, Wall St. J. (Sept. 29, 2014).

[4] Andrew J. Bowden, Address at Private Fund Compliance Forum 2014: Spreading Sunshine in Private Equity (May 6, 2014), *available at* www.sec.gov/News/Speech/Detail/Speech/1370541735361.

enforcement actions. In September 2014, the SEC instituted a settled action against New York investment advisory firm Lincolnshire Management, alleging that the firm had misallocated expenses between two private equity funds it managed.[5] The two funds each owned separate companies, which the investment advisory firm subsequently integrated. However, according to the SEC, the firm at times misallocated certain portfolio company expenses between its funds, or failed to document such allocations. The SEC charged the firm with failing to design appropriate compliance procedures to ensure proper allocation, assessing over $2 million in disgorgement and penalties.

Earlier this year, the SEC charged Arizona private equity fund manager Clean Energy Capital and its principal with improperly paying for over $3 million of the firm's expenses from 19 different private equity funds it managed.[6] According to the SEC, the adviser had improperly charged the funds for expenses such as rent, salaries, and employee benefits, as well as a $100,000 bonus paid to the principal himself. The SEC further alleged that the firm had loaned money to the funds at high interest rates in order for the funds to pay the manager's expenses.

Other 2014 enforcement actions alleged unauthorized fees that appeared more akin to misappropriation. In September 2014, the SEC charged a hedge fund manager for taking excess management fees for personal use, including remodeling his home and purchasing a luxury sports car.[7] The firm terminated the manager as soon as it became aware of his wrongdoing, reimbursed the hedge fund for the loss, and settled charges with the SEC for $150,000 and an agreement to retain a compliance consultant. And back in January, the SEC targeted a private equity fund manager for allegedly using sham due diligence fees in order to steal $9 million from the fund.[8] In that case, the SEC obtained an emergency court order freezing the assets of the manager and his firm.

Marketing and Valuation

OCIE Director Bowden also addressed on multiple occasions the staff's concerns about marketing materials used by private equity funds and hedge funds. Bowden cited instances where firms advertised performance without sharing their methodology or fundamental information that would give color to those results.[9] For example, OCIE has challenged the "cherry picking" of comparables in comparative analyses and the undisclosed use of projections in lieu of actual valuations.

As a particularized type of marketing data, OCIE has been particularly critical of methodology and disclosures around asset valuation. Though OCIE (and Enforcement) have identified the valuation of illiquid assets as a core concern in the investment adviser arena for several years, particularly where overvalued assets lead to the collection of inflated fees, Bowden has also cited valuation as a means of inflating the performance of funds still being marketed to investors.[10] While Bowden emphasized that OCIE is not typically focused on second-guessing valuation determinations (unless such determinations are "clearly erroneous"), he expressed concern about situations where funds fail to comply with their disclosed methods of valuation, or change their methodology from period to period. Director Bowden has reassured fund managers that OCIE's goal is not to challenge the fund's valuation itself but rather to scrutinize the method employed compared to the method disclosed to investors.

Compliance and Custody

OCIE has also used its bully pulpit to reiterate the importance of developing and abiding by effective compliance programs. Bowden has emphasized the need for private fund management to support compliance

[5] SEC Press Release, *SEC Charges New York-Based Private Equity Fund Adviser With Misallocation of Portfolio Company Expenses* (Sept. 22, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370543006673.

[6] SEC Press Release, *SEC Announces Charges Against Arizona-Based Private Equity Fund Manager in Expense Misallocation Scheme* (Feb. 25, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370540849548.

[7] SEC Press Release, *Former Hedge Fund Manager in Bay Area Charged With Taking Excess Management Fees to Make Lavish Purchases* (Sept. 17, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370542975721.

[8] SEC Press Release, *SEC Charges Manhattan-Based Private Equity Manager with Stealing $9 Million in Investor Funds* (Jan. 30, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370540703682.

[9] ACA Compliance Group, *supra* note 2.

[10] Bowden's May 6, 2014 speech cited supra note 4; *see also* A. Ackerman, *SEC Finds Deficiencies at Hedge Funds*, Wall St. J. (Sept. 22, 2014).

efforts and provide Chief Compliance Officers with the resources and support necessary to do an effective job. While some of the rules are undoubtedly technical and don't necessarily implicate more serious violations, both OCIE and the Enforcement Division continue to focus attention on arguably minor compliance issues. Indeed, the SEC Chair has publicly proclaimed a "broken windows" strategy under which even lesser violations are pursued by the agency and registrants may be criticized by OCIE, or even sued by the Enforcement Division, for compliance deficiencies that arguably cause no losses or investor harm.

The custody rule, in particular, remains a frequent subject of SEC attention. Just recently, in late October, the SEC charged private fund manager Sands Brothers Asset Management with violating the custody rule by providing late audited financial statements of its private funds.[11] The custody rule requires advisory firms with custody of client assets to distribute audited financial statements to fund investors within 120 days of the end of the fiscal year, a deadline that Sands Brothers repeatedly missed. Although the SEC did not allege any actual loss of investor assets, it is nonetheless pursuing action against the firm and its two co-founders, as well as its CCO. The SEC's case appears to have been prompted in part by the repeated nature of the violations, including a 2010 enforcement action against the firm for the same violation.

Insider Trading

Finally, while OCIE has been less vocal of late in highlighting insider trading as a priority area for the exam program, the Enforcement Division continues to bring a steady stream of insider trading cases with significant implications for private funds. The SEC's (and Department of Justice's) broad sweep against the exchange of information among public company insiders, expert networks, and private funds since the Galleon scandal has largely slowed, but new cases continue to arise.[12] The SEC has also been probing the leakage of nonpublic information in advance of public moves by activist hedge funds.[13] And at least according to press reports, the SEC is actively investigating the alleged use of political intelligence by hedge funds.[14]

In addition to pursuing the underlying insider trading charges, the SEC has continued to pursue securities registrants for failing to implement adequate controls to prevent trading on material nonpublic information. For example, in September the SEC charged a broker dealer with failing to maintain adequate controls to prevent one of its employees from trading based on a customer's information.[15] And in August, the SEC charged a broker with failing to enforce its compliance procedures governing the firm's maintenance of a restricted list and the reporting of personal securities transactions.[16] As the agency has demonstrated, the SEC will at times pursue investment advisers for compliance deficiencies even where the SEC does not find that illegal insider trading actually occurred.

Preparing For The (Almost) Inevitable

Newly registered private funds that have not yet been examined by the SEC, as well as pre-Dodd-Frank registrants who have not been visited in recent years, need to take steps to prepare for a likely SEC examination in the near future. Waiting until the SEC shows up at the firm's doorstep is unlikely to be an effective strategy.

First, fund managers would be wise to review their disclosures around SEC priority issues such as fees, expenses, and valuation to ensure such disclosures are both sufficiently expansive to withstand the SEC's critical eye and consistent with the firm's actual practices. Similarly, the compliance policies of the firm should be reviewed to ensure there are adequate procedures surrounding these critical issues, as well as

[11] SEC Press Release, *SEC Announces Charges Against Investment Advisory Firm and Top Officials for Custody Rule Violations* (Oct. 29, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370543316114.

[12] *See, e.g.*, SEC Press Release, *SEC Charges Technology Company Insider in California with Tipping Confidential Information Exploited by Hedge Funds* (Apr. 23, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370541624596.

[13] SEC Press Release, *SEC Charges Two with Insider Trading on Pershing Square's Announcement on Herbalife* (Sept. 30, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370543071733.

[14] *See* B. Mullins, S. Pulliam and J. Chung, *Washington Trading Probe Broadens to Hedge Funds*, Wall St. J. (Sept. 10, 2014).

[15] SEC Press Release, *Wells Fargo Advisors Admits Failing to maintain Controls and Producing Altered Document, Agrees to Pay $5 Million Penalty* (Sept. 22, 2014), *available at* www.sec.gov/News/PressRelease/Detail/PressRelease/1370543012047.

[16] *In re Monness, Crespi, Hardt & Co*., Order Instituting Administrative and Cease-and-Desist Proceedings, Admin. File No. 3-16025 (Aug. 20, 2014).

perennial issues such as insider trading, the custody rule, and conflicts of interest. And advisers should similarly scrutinize all marketing materials, including offering documents and partnership agreements, to ascertain whether the representations, particularly those around performance, can be supported and that material information is not omitted or misstated.

Second, fund managers should give consideration, resources permitting, to retaining third-party experts to assist with a mock examination. Compliance consultants and experienced counsel can help identify compliance gaps and disclosure deficiencies, and suggest potential remedial measures before SEC examiners arrive on the scene. In doing so, compliance officers should be cautious to act in a way that preserves the attorney-client privilege to minimize the risk of creating a problematic roadmap for the SEC.

Finally, funds need to be prepared to move quickly in the event of an SEC examination. The SEC staff will typically give minimal advance notice before beginning an exam — sending an extensive document request with a brief response time, followed shortly thereafter by an on-site visit — and it is important to avoid a last-minute scramble. Crucial documents should be well-organized and readily available to the CCO when needed. Management and key staff members should be familiar with and trained on the firm's policies and procedures; the best compliance manual in the industry won't protect a registrant if the firm's management and staff is unfamiliar with its provisions.

Funds that have already been examined by the SEC have one additional focus area. If a prior exam found deficiencies (and an exam finding no deficiencies at all is highly unusual) and the fund pledged to take remedial measures, the SEC staff will carefully scrutinize whether the firm has lived up to its representations. Both OCIE and the Enforcement Division are particularly attuned to recidivism, and even a minor violation may result in an enforcement action if the firm was put on notice of the issue during a past exam and failed to take corrective action.

Conclusion

The past several years have seen a sea change in the SEC's focus on investment advisers generally, and private fund managers in particular. Between the new Dodd-Frank registration regime and the Enforcement Division's establishment of a specialized Asset Management unit focusing primarily on hedge fund and private equity practices, both the exam and enforcement staff have dramatically stepped up the sophistication of their respective operations. Barring a new scandal akin to the financial crisis causing a redirection of SEC resources, private funds should assume that they will remain one of the top priorities for the SEC. A difficult examination poses serious risks to registrants, while an enforcement action could be the death knell for a firm (and a career-ender for its principals). For funds which have been taking a wait-and-see approach to reviewing their practices, disclosures, and compliance policies, the time to take proactive steps to prepare for a visit from the SEC is now. ■