

IAA Investment Adviser Compliance Conference

Private Equity Fund Advisers: Hot Topics in SEC Examinations Panel

Outline

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I. Preparing for an Exam

A. Criteria for choosing which advisers are examined

1. As of 2023, there were over 15,000 registered investment advisers, and the SEC was able to examine about 15% of registered investment advisers annually.
2. To determine which advisers are examined, the SEC has stated it applies a risk-based approach, which is based on both adviser disclosures and information obtained from third parties.
3. Examples of risks considered include:
 - a) Firms with supervisory concerns (i.e., disciplinary history relating to the adviser's personnel);
 - b) Firms with complex business models where the adviser is co-investing with clients;
 - c) Firms which have not been examined in a long period of time;
 - d) Newly registered firms;
 - e) Firms with material changes in leadership or ownership;
 - f) Firms with access to client assets;
 - g) Firms with recently identified issues relating to compliance programs disclosure documents, or marketing materials.

B. Composition of SEC personnel on exam

1. Local office vs. not
2. Private Funds Unit vs. regional
3. Lawyer vs. not
4. Enforcement vs. EXAMS only

C. Exam process

1. EXAMS usually calls adviser informing it of upcoming exam.
2. EXAMS then generally sends a formal letter, including an initial request list.
 - a) Number of requests varies widely, but usually includes 30-35 requests (but can exceed 80 requests). Examples of materials/subject matter include:
 - (1) Trade blotters;
 - (2) Compliance manuals and records of infractions;
 - (3) Fund documents;
 - (4) Schedule of fees and expenses;

- (5) Marketing and advertising materials;
 - (6) Investor complaints;
 - (7) Any threatened or pending litigation.
 - b) Initial production of requests is usually due within two weeks.
- 3. Once an initial request is responded to, the process for an exam and the timing for an exam often vary, but they usually include further requests and/or interviews.
 - a) Examiners generally interviews key employees/departments, such as finance, portfolio managers, and compliance.
 - b) Typically, there are multiple rounds of written follow-up requests.
 - c) Exams typically last around 6-9 months, but many are shorter or longer.
- 4. Exam may result in no findings, deficiencies, or a referral to enforcement.
 - a) No findings (infrequent)
 - b) Deficiency letter (most common)
 - (1) Identifies a variety of deficiencies depending on the nature of the firm's business.
 - (2) 30 days to respond in writing.
 - c) Referral to SEC Enforcement Division (infrequent)

D. Preparing for an exam

1. It is most critical to ensure the adviser has a well-run compliance program on an ongoing basis.
 - a) This includes having the adequate documentation of each aspect of the program.
 - b) Mock examinations, whether done by an outside party or internally, can be a useful tool in preparing for an SEC exam.
2. Consider who on the team, whether internal or external, is going to be responsible for certain portions of the exam process, ideally with backups.
 - a) For example, who will be the person tasked with coordinating internally and tracking the gathering of documents to respond to each item? Who might be tasked with coordinating with outside counsel to gather fund documents?
3. Consider what might be expected from an initial request list and begin gathering those materials to the extent possible.
 - a) In particular, prepare certain materials that the SEC has the expectation that the adviser is maintaining and updating in the regular course, such as a violations log, a risk matrix, or a trade blotter.
 - b) Obtain a list of the types of requests you might expect and start getting ready to fill those in from regulatory counsel or compliance consultants.
4. Similarly, prepare a "Day One" deck in advance with the expectation that it may need to be updated based on the actual requests, as we will discuss in more depth shortly.

E. “Day One” / “First Day” Deck

1. Outlines, among other things, the manager’s organizational structure, investment process, expense allocation procedures and compliance function.
2. Items to consider include:
 - a) Firm overview including ownership and history;
 - b) Firm affiliates (include org chart if complex);
 - c) Key personnel (functional org chart);
 - d) Types of clients/products;
 - e) Types of services including investment strategies offered;
 - f) Overview of marketing, compliance, valuation, fees/expenses.
3. While having an off-the-shelf version of a Day One deck prepared in anticipation of any future examination is recommended, what is actually presented to EXAMS should be tailored to address their specific issues or concerns.

F. Criteria for choosing interviewees

1. EXAMS will generally provide guidance on the interviewees it would like to interview, or at least the relevant departments or subject matter.
 - a) If given the option to select individuals, consider their substantive knowledge of the relevant issue, as well as their demeanor and credibility.

II. Current issues in private funds exams

A. Post-commitment period management fees

1. The SEC has paid increased attention to the calculation of fees after the end of a fund’s commitment period, particularly where the sponsor has a conflict of interest.
 - a) Post-commitment management fee calculations are a top three issue on virtually every closed-end fund adviser exam and should remain a high priority for compliance efforts.
 - b) The SEC is focused on what exactly adviser fund document say about how management fees are calculated, how write-downs and portfolio company reorganizations are accounted for, and whether adviser practices match what the documents state.

B. Affiliated service providers

1. EXAMS has shown a focus on conflicts, controls, and disclosures regarding investment advisers managing private funds and their use of affiliated service providers.
2. Examiners will usually review adherence to an adviser’s fiduciary duty standard, focusing on economic incentives that an adviser may have to recommend affiliated service providers.
3. Tasks performed by affiliated service providers may include asset-level due diligence, loan servicing, property management, accounting, in-house legal, fund administration, and other similar services typically performed by outside professionals.

4. Examiners will compare practices to disclosure, including the parties involved, descriptions of their services, how they are paid, and whether the adviser engages in any benchmarking.

C. Following disclosure (e.g., due diligence disclosures/ESG)

1. Examiners often review adherence to an adviser's fiduciary duty standard, focusing on disclosures and statements (e.g., through marketing or even more informally) made to investors and whether they include all material facts and are consistent with policies, procedures, and practices.

2. With respect to ESG in particular, the main concern is greenwashing – i.e., communicating to investors that advisers are taking ESG actions that they are not actually implementing.

3. Whether as related to due diligence disclosures more generally or on ESG specifically, it is important to ensure that disclosures and statements are accurate and align with policies, procedures, and practices.

4. In addition, on ESG, advisers should ensure cross-firm coordination, including among IR, legal/compliance, ESG, and investment personnel.

D. Marketing

1. EXAMS is likely to focus on whether advisers have:

a) adopted policies and procedures addressing the new marketing rules;

b) appropriately disclosed their marketing-related information on Form ADV;

c) maintained substantiation of factual claims and other required books and records.

2. Reviews will generally also assess whether advertisements are misleading and comply with requirements for performance (including hypothetical and predecessor performance), third-party ratings, and testimonials and endorsements.

E. Adherence to contractual requirements related to LPACs

1. Examiners generally focus on adherence to contractual requirements regarding limited partnership advisory committees or similar structures (e.g., advisory boards), including adhering to any contractual notification and consent processes.

2. They are likely to ask whether the LPAC is authorized under the LPA to make the required approval and whether it received disclosure of all material facts and conflicts.

F. Fees & expenses

1. Examiners have generally focused on allocation of certain fees and expenses among the investment adviser, the funds/clients, and/or co-investors, and clear, accurate, and timely disclosure of allocation practices.

2. Recent general fee and expense and allocation focuses include:

a) Calculation of management fees;

- b) Expenses not authorized by the LPA or governing documents (for instance, with respect to fund extensions, or compliance, examination and enforcement inquiry costs);
- c) Recycling provisions;
- d) Expenses not borne by certain funds despite shared benefit, e.g., “broken deal” costs;
- e) Allocation of financing costs;
- f) Expenses allocated to co-investors;
- g) Expenses of the adviser being allocated to a fund / investment that could be considered “overhead” (for instance, use of platform companies to employ certain firm individuals);
- h) Services of adviser personnel being charged to a client / investment (“in-sourcing”);
- i) Expenses benefitting adviser (such as insurance premiums).

G. Loans & guarantees

1. Loans and guarantees can lead to a number of inherent conflicts that EXAMS may review, including those between the adviser and funds or portfolio companies.
2. For example, EXAMS will expect advisers to have considered and/or disclosed, as appropriate, whether the loans or guarantees are in the best interests of the clients involved, whether terms are “market”, and capital structure conflicts.

H. Crypto-assets and emerging financial technology

1. For crypto, examiners typically assess appropriate standards of conduct, particularly the duty of care; the routine review, update, and enhancement of compliance practices (including crypto wallet reviews, custody practices, Bank Secrecy Act compliance reviews and valuation procedures); operational resiliency practices (i.e., data integrity and business continuity plans); compliance with the custody rule; and appropriate risk-disclosure.
2. According to EXAMS’s 2024 Priorities Report, it remains focused on automated investment tools, artificial intelligence and trading algorithms or platforms, and the risks associated with the use of emerging technologies and alternative sources of data.