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PERSPECTIVE

Strategies for fund managers to avoid SEC pitfalls

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Whether you are a first-time fund, exempt adviser or registered investment adviser, all funds must be mindful of implementing an organizational structure grounded in compliance. This involves weaving together strong operational, technological, commercial and cultural elements, all of which have a foundation of compliance with SEC rules. Fund managers have many potential land mines to consider and proper adherence to structure and policy from the beginning will ensure a much more robust approach and help ensure success in any SEC exam or investigation. Luckily, the SEC provides great transparency regarding their priorities and concerns to fund managers, even providing observations from examinations that offer insight into common deficiencies and challenges faced by other funds. These insights provide an important foundation to the development of any fund compliance approach.

If you are in the asset management industry, you can be assured if you are successful and continue to grow your fund and assets under management, it is highly likely you will come into contact with the SEC at some point even if only through a routine examination.

Common Deficiencies

Fund managers are a source of intense focus for the SEC, predominately because funds manage the assets of pensions, charities, endowments, families and many other individuals and entities. The SEC seeks to protect investors and their examination of hundreds of fund managers every year provides them with the tools for pattern recognition when it comes to common issues and problems. These common issues allow the SEC to set their agenda for subsequent years and identify areas of focus when it comes to examination priorities. In 2020, the SEC identified conflicts of interest, fees and expenses and policies and procedures relating to material non-public information (MNPI) as three areas of deficiency for fund managers. These same areas, among others, have surfaced as deficiency areas in prior years as well.

Conflicts of Interest — Section 206 of the Investment Advisers Act of 1940 prohibits investment advisers from employing any device, scheme or artifice to defraud any client, and from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client. The SEC noted common conflicts of interest deficiencies include conflicts related to allocations of investments; multiple clients investing in the same portfolio company; financial relationships between investors and the adviser; preferential liquidity rights; adviser interests in recommended investments; co-investments; service providers; fund restructuring; and cross-transactions.

While disclosure is not the cure for all conflicts of interest, the beginning of ensuring proper conflicts of interest disclosure is in the fund's private placement memorandum (PPM) and limited partnership agreement (LPA). In the risk factor section of the PPM and in the investment provisions of the LPA, there is an opportunity to alert investors to potential conflicts of interest as well as draft broad language that will cover many types of transactions. In addition to the PPM and LPA, fund managers should develop robust policies and procedures that outline what actions must be taken when a conflict of interest is identified and ensure compliance with such procedures. This may involve getting a vote of limited partners or a limited partner advisory committee or simply just providing investor disclosure prior to engaging in a particular transaction. Finally, when it comes to allocation of investment opportunities and co-investments, fund managers should ensure they consider the interests of all limited partners when opportunities arise and aim to avoid favoritism. The LPA is a good place to outline procedures, so all investors are clear about who has access to such opportunities and what process is followed. Again, while disclosure alone is not sufficient to ameliorate all conflicts of interest, it is the most fundamental aspect of managing such concerns. It also brings a level of transparency that can help fund managers identify when a conflict rises to a level where

additional process or procedure is necessary.

Fees and Expenses — With respect to fees and expenses, the key identified deficiencies include allocation; the use and compensation of operating partners; valuation; and monitoring offsets. The key causes resulting in these deficiencies is failure to follow written documentation (such as the provisions outlined in an LPA or a fund's policies and procedures). To help ensure compliance, funds can be explicit in the LPA and PPM when describing the expenses to be paid by the fund and its investors. Such detail should include specific types of expenses and indicate whether fund investors will be responsible for paying all or a portion of compensation payable to operating partners or other advisor costs. In addition, explicit disclosure regarding the types of fees factored into the management fee offset as well as the calculation of such offset are critical disclosure components.

On the operational side, funds should have their legal and finance teams work together to parse through the legal documentation and ensure financial expenses are being properly categorized and allocated. Such discussions and work can be the basis for developing policies and procedures that provide a direct connection between the words on the page and the practical implementation. Finally, annual audits are another way to conduct a check to ensure any LPA amendments or other operational changes in practice are picked up and used to revise policies and procedures accordingly.

Policies and Procedures Regarding MNPI — Section 204A of the Advisers Act requires investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI. This includes adopting a code of ethics. The two key issues identified were failure to adequately cover risks and failure to enforce. Fund managers often fail to recognize all of the access points when it comes to protecting against misuse of MNPI. This includes access to information through offices and systems and interaction with outside consultants or other advisors. Fund managers quite often fail to enforce their own policies around such things as trading restrictions.

In addition to the obvious strategy of adopting a robust code of ethics, fund managers should consider and address two operational aspects: access and education. For access, technical approaches can be utilized to ensure certain electronic information is only accessible by specific individuals in an organization. Systems can monitor compliance to ensure swift enforcement is implemented when there is a breach. Education is the other key strategy. Many individuals who work for fund managers may not understand or realize the importance of protecting MNPI. Proper training is key and such training must be done regularly and repeatedly as a reminder. Education provides an opportunity to convey new examples of misuse, alert individuals to enforcement actions and update fund personnel about changes in policies and procedures. Vigilance in enforcement is an important strategy but basic infrastructure and education go a long way towards minimizing the need for enforcement as personnel can begin to understand how to police their own behavior when it comes to MNPI.

Avoiding the SEC Hot Seat

If you are in the asset management industry, you can be assured if you are successful and continue to grow your fund and assets under management, it is highly likely you will come into contact with the SEC at some point even if only through a routine examination. As such, it is critically important to understand the common areas of deficiency and develop organization structures to ensure your fund is compliant. Since areas of deficiency often end up as examination priorities in subsequent years, it is important for a fund to monitor these. Funds can then use these deficiencies as opportunities to update and innovate their structures, policies and procedures, as well as continue to educate their teams especially as the fund grows in size and scale. ■

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