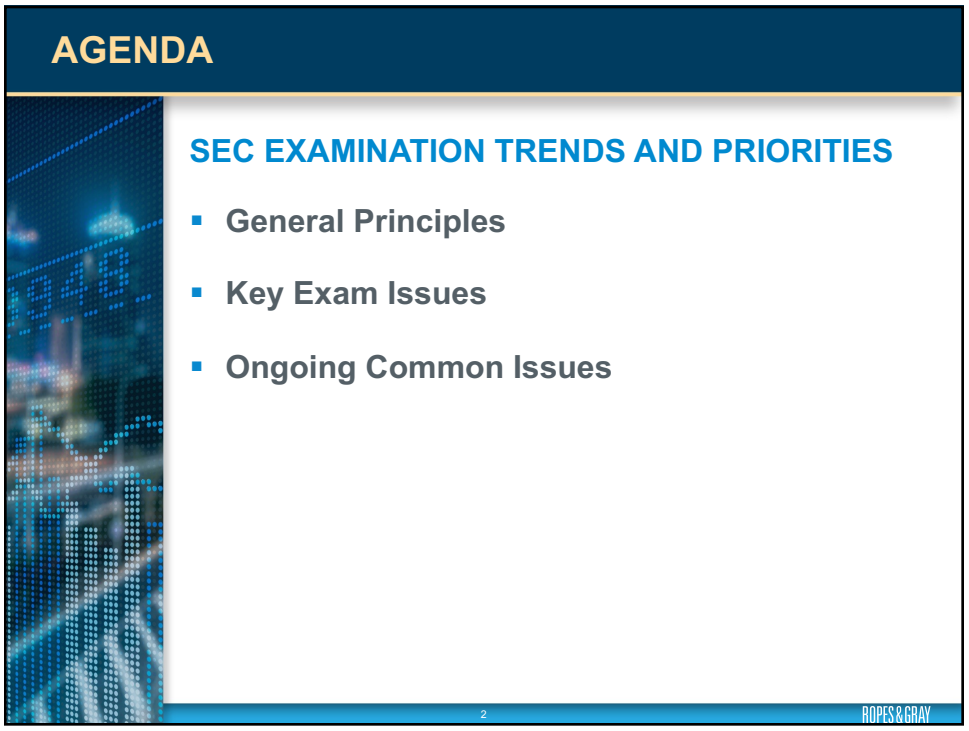

ROPES & GRAY
SEC EXAMINATION TRENDS AND PRIORITIES
ROPES & GRAY

1


AGENDA
SEC EXAMINATION TRENDS AND PRIORITIES
General Principles
Key Exam Issues
Ongoing Common Issues
2
ROPES & GRAY

2

AGENDA

SEC EXAMINATION AND ENFORCEMENT TRENDS

- General Principles
- Key Exam Issues
- Ongoing Common Issues

3

FOSTERING A CULTURE OF COMPLIANCE

- Employee obligations are set out in the adviser's compliance manual and Code of Ethics, along with other policies and procedures
  - Compliance and Code of Ethics are not optional or aspirational
  - De minimis violations or exceptions can result in substantial liability
- "Tone at the Top"
  - Senior people should be visibly involved in:
    - Attending trainings
    - Sending annual emails
    - Modeling ethical behavior
    - Compliance Resources
- **Do Not** ignore "red flags" or suspicious activities
- Employees must promptly report any known or suspected violation of the company's policies and procedures
- Failure to report a violation could result in disciplinary action, ranging from a reprimand to termination of employment
- A cover up can be worse than the offense

4

FIDUCIARY DUTY

- Advisers Act imposes on investment firms a broad fiduciary duty to act in the client's best interests.
  - Client = Fund (and not the investors in a Fund)
  - Affirmative duty of undivided loyalty and utmost good faith, full and fair disclosure of all material facts
  - Affirmative duty to have a reasonable, independent basis for investment advice
  - Affirmative obligation to use reasonable care to avoid misleading clients
- Disclosure-based fiduciary duty
- Investment adviser must guard against conscious and unconscious incentives (e.g., conflicts) that might cause the adviser to fall short of providing disinterested advice
  - Investment adviser may be faulted even when it does not intend to injure a client, and even if the client does not suffer a monetary loss
- Advisers Act fiduciary duty does not create investor right of action against an adviser
  - Instead, SEC given the right to police the duty through examination of advisers and enforcement powers

5

AGENDA

SEC EXAMINATION AND ENFORCEMENT TRENDS

- General Principles
- **Key Exam Issues**
- Ongoing Common Issues

6

KEY EXAM ISSUES

- Affiliated Service Provider Arrangements
- Fee & Expense Allocation Practices
- Valuation
- Fund Restructurings
- MNPI Management & Insider Trading
- Marketing and Presentation of Performance
- Electronic Messaging
- Undisclosed Conflicts of Interest
- Compliance with Investment Restrictions
- ESG-Related Issues

7

AFFILIATED SERVICE PROVIDER ARRANGEMENTS

8

AFFILIATED SERVICE PROVIDER ARRANGEMENTS

The SEC continues to focus on affiliated service provider arrangements, with a focus on proper treatment of services provided and accurate disclosure of services

The SEC has continued to shift its emphasis from a lack of disclosure to the implementation of the activities covered by the disclosure

- As advisers have included appropriate disclosure on the particular arrangement, the SEC now scrutinizes the underlying practice to determine if the disclosure matches the implementation of that practice

The focus can take many forms, including:

- Where an adviser promises to charge fees at market rate, challenging whether the fees charged were actually consistent with market rates and the benchmarking analysis (company level versus fund level; discounts; appropriate comp sets; frequency of benchmarking);
- Equity payments to the service providers if equity payments are not specifically disclosed (e.g., carry or other performance-based compensation);
- Services performed by personnel different than those described (e.g., stating that an operating partner's costs may be charged is different than stating an employee's costs may be charged);
- Performing types of services that are not described (e.g., the LPA allows tax and legal services, and the firm charges for services related to human resources; providing "on-site" property management services from the adviser's offices);
- Ignoring certain prohibitions in the LPA (e.g., provisions that limit travel expenses prior to investment in the company, or provisions that do not allow expenses of a service provider to be charged if a fee is already being charged by that service provider);
- Inclusion of overhead costs in the expense reimbursement unless those costs are specifically called out;
- Charging of salary, bonus, benefits, payroll taxes; and
- Allocations of time/expenses/cost without back-up or sufficient precision.

9

AFFILIATED SERVICE PROVIDER ARRANGEMENTS

General affiliate-service and expense disclosures will not prevent the Staff from investigating the following:

- Do investors know what services are performed by affiliates?
- Do investors know what affiliate salaries are charged (e.g., the LPA allows for tax and legal services but not for HR-related work)?
- Are there any charges for services that are not described in the Fund documents?
- Is the adviser now charging for services that were previously performed for free (i.e., previously within services paid for by the management fee)?
- Do advisers normally provide these services in their regular course of business (e.g., consultants performing diligence or sourcing)?
- Is overhead charged? Is its allocation clear to investors?
- Are all affiliate payments properly accounted for in management fee offsets?
- How does the adviser ensure affiliate fees are consistent with or preferable to market rates?
- Is there sufficient data to support accurate expense and salary allocation?
- Does the adviser clearly disclose its practices relating to fees and expenses and allocation thereof?

10

FEE & EXPENSE ALLOCATION PRACTICES

11

FEE & EXPENSE ALLOCATION PRACTICES

The Staff still focuses on allocation of certain fees and expenses among the investment adviser, the funds and/or co-investors, and clear, accurate and timely disclosure of allocation practices

Recent general fee and expense and allocation focuses include:

- Calculation of management fees (for instance, with respect to partial realizations, dividends, write-downs/write-offs);
- Expenses not authorized by the LPA or governing documents (for instance, with respect to fund extensions, or compliance, examination and enforcement inquiry costs);
- Recycling provisions
  - Potential conflicts if management fees charged on additional recycled amounts;
- Expenses not borne by certain funds despite shared benefit, e.g., "broken deal" costs;
- Allocation of financing costs of carrying an investment (including costs related to establishing credit facilities);
- Expenses allocated to co-investors (e.g., insurance, closing costs, borrowing costs);
- Interest costs for a fund borrowing to pay for management fees or placement agent fees;
- 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);
- Services of adviser personnel being charged to a client / investment ("in-sourcing");
- Excessive fees and expenses (such as luxury travel, premium meals and entertainment); and
- Expenses benefitting adviser (such as insurance premiums, intangible benefits and mixed-use travel).

12

VALUATION ISSUES

13

VALUATION ISSUES

The Staff has focused on a variety of issues related to the adequacy of valuation policies and procedures:

- Changes in methodology (for the same investment, among different investments)
  - Sufficient documentation of rationale
  - Sufficient disclosure of any changes (including any impact that the COVID-19 crisis has had on determining valuations);
- Review and testing of valuations, including back-testing after sales to confirm reasonableness;
- Consistency with valuation procedures; and
- Use of independent third-party pricing vendors.

Valuation-related issues tend to focus on process and disclosure rather than actual valuation used

The Staff has scrutinized instances where advisers take full management fees even when the value of an asset is plummeting

- In these situations the Staff has (1) challenged the valuation itself; (2) accepted the valuation but argued the valuation should have triggered a reduction standard; and (3) questioned whether the reduction standard had been met sooner than the adviser determined (particularly for companies that eventually became worthless)

Key Takeaways

- Advisers should consider carefully the valuations of companies that have decreased in value and whether they meet the standard for decreasing the management fee paid by a fund
  - The SEC will review such determinations with the benefit of 20/20 hindsight
- The Staff may find deficiencies even where the advisers' management fee practices are permitted by the LPA, but where the Staff feels that facts were not adequately disclosed to LPs
- Demonstration of solid valuation reviews with good documentation as to potential future valuations is key, especially given the lack of clear guidance as to what "written off" or "written down" means

14

FUND RESTRUCTURINGS

15

FUND RESTRUCTURINGS

The Staff has scrutinized a variety of issues related to fund restructurings (Continuation Funds, Cross Trades):

- Determination of fair valuation for the assets being transferred
  - How did the adviser determine the price was in the best interest of the selling and purchasing funds?
  - Fairness opinions; use of separate third-party valuation agents
- Disclosure of conflicts of interest
  - Crystalizing carry or performance fees on the assets
  - Continued receipt of management fees / increased change of receiving carry or performance fees going forward
  - Other advantageous economics for the adviser
  - Clients who may have differing interests in a restructuring transaction
- Allocation issues
  - Between any Continuation Fund (or successor vehicle) and any rollover investors
- Disclosure of economics for rollover investors
- Stapled secondaries in connection with a fund restructuring

16

MNPI MANAGEMENT & INSIDER TRADING

17

MNPI MANAGEMENT & INSIDER TRADING

The SEC Staff remains focused on the need for MNPI policies and procedures that account for the specific risks inherent in an adviser's business:

- Both as a window into potential trading impropriety, and a standalone compliance policy issue

Recent deficiency examples related to the control of material non-public information:

- Restricted lists that failed to account for (i) information learned and NDAs executed by separate business units on same side of wall, and (ii) "adjacent" public companies;
- Employees communicating across an information barrier in potential violation of firm policy;
- Investment-related communications among employees of separate investment advisers located in the same office building, in potential violation of compliance policies; and
- Inadequately tailored email reviews involving employees with spouses employed at other registered investment advisers.

The Staff has also continued to focus on polices and procedures governing:

- Communications with public company employees, and "active monitoring" by compliance; and
- The use and tracking of expert networks, political consultants, and data service providers.

The Staff continues to ask about *Ares* procedures on exams

- Requests related to compliance approval of trades in issuers on the restricted list and applicable policies and procedures to address any potential conflicts and MNPI issues; and
- Follow-up requests for documentation of compliance assessment and rationale for approving trades in issuers on the restricted list, specifically those where the adviser has public company board representation.

18

MNPI MANAGEMENT & INSIDER TRADING

Recent MNPI issues of interest:

- "Adjacency issues": Trading in one company with the benefit of information received from a different company;
- Alternative data providers;
- Value-add investors; and
- Expert networks.

Mitigation of Insider Trading Risk

- Identify high-risk sources of MNPI based on your specific business practice, such as personal relationships, consultants, confidentiality agreements, etc.
- Review and enhance insider trading compliance programs, especially with respect to exchanging information with third parties, and consider implementing changes in response to *Ares*.
- Conduct periodic email surveillance and trade back-testing (or work with a vendor to provide these services, which can be tailored to firm's risk profile).
- Conduct targeted trainings around MNPI and related compliance policies.
- Adequately document approvals for trades on restricted lists.
- Implement clearly defined process for timely removal of issuers from restricted lists.

19

MARKETING AND PRESENTATION OF PERFORMANCE

20

MARKETING AND PRESENTATION OF PERFORMANCE

The Staff has continued its interest in marketing materials, in particular regarding performance calculations and appropriate disclosures including with respect to:

- Use of Subscription Lines / Credit Facilities:
  - Both levered and unlevered IRR calculations;
  - Any specific disclosures to actual or potential investors, including to an LPAC, about the impact that a credit facility has on the net IRRs of levered funds; and
  - Maximum length of time for which a subscription line has been outstanding.
  - Note this was not addressed in the New Marketing Rule but may be addressed in new proposed private fund reform rules
- Use of Recycling
  - Analysis of the effect recycling proceeds had on a fund's IRRs and multiples
- Calculation of net IRR [New Marketing Rule FAQ]
  - Inclusion of non-fee-paying investors (e.g., GP / employee co-invest vehicles);
  - Multiple classes of fees (blended returns versus highest fee-paying returns); and
  - Explanation of calculation.
- Predecessor Adviser Track Records
  - Clear disclosure of track records from prior firms and how attributable investments were identified
- Hypothetical performance

21

ELECTRONIC MESSAGING

22

ELECTRONIC MESSAGING

- Rule 204-2(a)(7) of the Advisers Act sets forth specific categories of documents that must be retained, including written communications sent and received "relating to . . . any recommendation made or proposed to be made or any advice given or proposed to be given. . . ."
  - In practice, however, the SEC has **not** limited its investigation solely to those communications contemplated by the plain language of the Advisers Act and has instead taken a much broader view of advisers' preservation obligations.
- This has led to a multi-round "sweep" investigation which, as of earlier this year, had already resulted in nearly $2 billion in fines on large broker-dealers and their affiliates (including certain RIAs).
  - Notably, in the second sweep the SEC **demanded the production of actual off-channel communications – including those maintained on employees' personal devices**
- The SEC may pressure asset managers under Section 203(e)(6) of the Advisers Act, which requires asset managers to supervise employees to prevent policy violations.
- In some scenarios, the SEC could seek charges under Rule 206(4)-7 of the Advisers Act, which require a registered investment adviser to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

23

ELECTRONIC MESSAGING

- SEC Expectations During Investigation:
  - Investment advisers are tasked to evaluate the electronic communication practices for a representative sample of senior personnel and their direct reports (including text messages on their personally owned mobile devices).
- Emerging Themes:
  - The SEC seems to view even a small number of such off-channel communications as violative.
  - Penalties seem driven more by the size of entities as opposed to the number of violations.
  - The SEC has indicated that it may be open to mitigation arguments based on the existence of a strong compliance program that seeks to identify and reprimand employees that engaged in off-channel communications.
- Best Practices:
  - Effectively implementing capture technologies for electronic communication channels (e.g., SMS, iMessage, WhatsApp, etc.) along with consideration of whether and how to allow private mobile communication tools to be used for business in conjunction with employee training, strengthening policies, and monitoring and enforcement of the same, will be key steps toward compliance for firms regardless of whether they become targets in the sweep.

24

UNDISCLOSED CONFLICTS OF INTEREST

25

UNDISCLOSED CONFLICTS OF INTEREST

The Staff continues to focus on undisclosed conflicts of interest between the adviser and funds, as well as among different funds and clients, including:

- Undisclosed receipt of more favorable service provider treatment than funds (legal fee discounts);
- Undisclosed terms of loan arrangements between adviser, its affiliates or its fund investors and funds or investments;
- Undisclosed investments in the same company at differing seniority or priority levels and/or valuations, potentially favoring one client over another;
- Undisclosed use of one fund's information for the benefit of another fund;
- Undisclosed use of alternative data; and
- Undisclosed personal conflicts, including personal investments and outside business activities.

26

ESG-RELATED ISSUES

27

ESG-RELATED ISSUES

The Staff identified ESG as a key priority in 2021, 2022 and 2023

Examinations of advisers claiming to engage in ESG investing will focus on three key areas:

- Portfolio management (i.e., a review of ESG policies, procedures, and practices; due diligence and processes for selecting and monitoring investments according to disclosed ESG investing approaches; and ensuring proxy voting decision making is consistent with ESG disclosures);
- Performance advertising and marketing (i.e., a review of filings, marketing materials, responses to DDQs, and other similar materials that commit to follow certain ESG frameworks); and
- Compliance programs (i.e., a review of written policies and procedures regarding ESG investing practices and their implementation and oversight).

The Staff has flagged deficiencies and internal control weaknesses related to ESG investing:

- Portfolio management practices were inconsistent with disclosures about ESG approaches;
- Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates and restrictions;
- Proxy voting may have been inconsistent with advisers' stated approaches;
- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches;
- Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices; and
- Compliance programs did not adequately address relevant ESG issues.

New disclosure requirements in proposed rules

28

AGENDA

SEC EXAMINATION TRENDS AND PRIORITIES

- General Principles
- Key Exam Issues
- Ongoing Common Issues

29

ONGOING COMMON ISSUES

Cross Trades and Principal Transactions

- Adequacy of disclosures
- Failure to obtain consent until after the transaction (for principal transactions)
- Failure to recognize that adviser's own significant ownership interest in a fund could result in a principal transaction
- Fund restructurings

Allocation of Investment Opportunities

- Across clients and overlap situations, including across affiliates and future businesses
- Co-investments (disclosures and duty to offer requirements)
- Consistency with policies and disclosures

Cybersecurity

- Outside of sweeps, cybersecurity-related requests are rare, unless there has been a breach
- Requests generally focus on data loss and prevention, vendor management, incident response, policies and procedures relating to the ongoing maintenance and review of electronic and cloud-based storage of customer records, etc.

30

ONGOING COMMON ISSUES

Custody Rule

- Failure to recognize custody of client assets
- Technical violations
- Proposed New Safeguarding Rule

Internal Vehicles & Co-Invest

- Client status
- Allocation

Form ADV/PF

- Timely filings
- Accuracy and consistency

Alternative Data

- Establish due diligence procedures for evaluating and vetting alternative data vendors and their techniques (both initial and periodic, ongoing diligence)
- Ensure appropriate contractual protections from data providers

31

ONGOING COMMON ISSUES

Cryptocurrency

- Trading and custody issues
- Status as a security
- Procedures for losses
- Valuation

Whistleblower / Confidentiality

- Confidentiality provisions in employment agreements cannot prohibit personnel from reporting violations
- SEC interprets even general confidentiality provisions without carve-outs to violate the applicable rules

Political Contributions / Pay-to-Play

- SEC searches public records to review political contributions
- Focus on contributions by an adviser's affiliate to a government entity investor in a fund managed by the adviser

Compliance Policies and Procedures

- Violations typically arise only if there is an underlying issue (i.e., there is unlikely to be a deficiency related to an adviser's Custody Policy unless there is an underlying violation of the Custody Rule)

32