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Private Funds Should Prepare For More SEC Oversight In 2022

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Growth in the private funds industry has been exponential in recent years and shows no sign of slowing down.

Industry experts estimate that investors pay private equity and hedge funds more than $250 billion a year in fees and expenses, which does not even account for additional ancillary fees from limited partners and portfolio companies.

And while regulation and oversight of the more than 32,000 private funds registered with the U.S. Securities and Exchange Commission[1] has increased at both the state and federal level, the commission allocated more resources to protecting traditional retail investors under former SEC Chair Jay Clayton than policing the accredited investor space.

Private funds should prepare, however, for a dramatic change to that approach as 2022 begins.

On Nov. 10, SEC Chair Gary Gensler gave a speech at the Institutional Limited Partners Association Summit[2] that touched on a variety of topics related to the SEC's evolving priorities concerning private funds, an industry with more than $17 trillion in gross assets under management for U.S.-based funds.

Gensler's remarks follow a multiyear trend of enhanced SEC oversight of private funds, and served as a renewed call by the commission to increase transparency in an industry historically marked by opaque disclosures and limited avenues for investors to access meaningful information.[3]

Gensler's comments reflect a growing awareness that private fund investors consist of wealthy individuals and companies, but also an increasing number of retirement and government pension plans.

At bottom, then, many ultimate investors in private funds are effectively everyday, less sophisticated investors who sit at the center of the SEC's protective mission.

When we consider the motivation behind the SEC's continuing focus on private funds, we should look at it through this lens. The SEC may not necessarily be trying to further safeguard the assets of the wealthy, but to diligently ensure that the interests of average investors are protected.

Enforcement and exam priorities have therefore publicly shifted to reflect the desire to protect average investors through robust regulatory oversight of the core aspects of private funds.

As the chair noted, given the indirect exposure such investors have to private funds, regulators would like to "bring more sunshine and competition to the private funds space."[4]

Below we address three key areas that private funds — particularly investment advisers, compliance officers and counsel — should pay specific attention to in the new year, through enhanced compliance policies and procedures, as well as commonsense approaches to fund management.

Fees and Expenses

Gensler's speech highlighted that private funds should be promoting additional transparency around fees and expenses, particularly given the multiple layers of fees such funds have.

In addition to management and performance fees, many funds charge investors monitoring fees, board fees or other portfolio company fees.

The well-known two-and-20 structure for management and performance has remained relatively constant over the past decade, while more traditional investment products — such as individual retirement accounts and brokerage accounts — have featured dramatic fee reductions through increased competition.

Gensler noted that he would like to see similar increased competition in the private fund space through enhancement of the nature and clarity of investor disclosures.

How can funds accomplish this?

Ensure accurate fee billing and expense practices.

Fund advisers should work in close consultation with their compliance teams to adopt and implement written policies and procedures reasonably designed to prevent inaccurate fee billing and expense practices.[5]

As a comprehensive June 2020 SEC risk alert for private fund managers announced, for disclosure to be "full and fair, it should be sufficiently specific so that a client is able to understand" it.[6]

In particular, advisers should consider whether the disclosures concerning fees and expenses are specific enough to provide investors with a true understanding of how those costs are calculated and the efforts undertaken to ensure accuracy in their calculation and allocation.

The staff of the SEC's Division of Examinations has made clear that in connection with routine exam activities across regional offices, staff will undertake a recalculation of relevant fees and expenses as appropriate.[7]

The exam staff also expects funds to have all necessary backup information readily available to confirm the reliability of fees and expenses charged to investors. This issue should be of particular focus for funds in the post-commitment stage, where write-downs and write-offs have occurred.

Conduct an internal audit.

Funds should strongly consider undertaking an internal audit of their allocated expenses measured against the disclosures made in offering documents and partnership agreements concerning investor responsibility for fund expenses.

Most funds limit charged expenses or specifically identify expenses to investors in connection with fund management.

In particular, allocation of shared expenses must conform to the correspondent disclosures to specific fund investors.

Exam staff has expressed concern that many advisers do not adhere to written policies and procedures or investor disclosures when allocating expenses across funds and, as a result, certain investors overpay.[8]

Consistent and substantive review and monitoring of shared expenses — which can include overhead for adviser personnel, compliance, regulatory filings and office expenses — provide an extra layer of protection, and will likely be viewed as a welcome enhanced compliance procedure by potential investors.

Preparation is key.

Private funds should maintain a robust and dynamic checklist to use in preparation for regulatory exams. This checklist should identify, at minimum:

- Each fee and expense charged to the investor, with special attention given to adviser compensation and reimbursable adviser expenses;
- The source of the cost disclosure to investors, i.e., the provision of the fund operating agreement providing for the fee or expense;
- The method of calculation, and location and names of supporting documents used in the calculation;
- Agreements with third parties for outside expenses; and
- Any investor inquiries or complaints concerning a fee or expense.
- The source data and methodology for valuation of portfolio assets, discussed below, will likely be a key focus of inquiry in any exam or enforcement review.

Where outside software is relied upon to calculate fees or supplement in-house accounting, advisers and compliance personnel should maintain written policies and procedures to update such software when fee structures or formulas change, and maintain responsibility for incorporating software changes into their calculation efforts.

Be proactive.

Advisers should consider taking preemptive remedial action to address any situations in which a fund discovers an error in the calculation of fees or expenses charged to investors, including prompt disclosure to investors and potentially self-reporting ahead of regulatory intervention.

Any such efforts should be undertaken in close consultation with counsel and compliance personnel, and the efforts should ensure that the source of the error is addressed and comprehensively documented.

Valuation Policies

For years, the SEC has paid closer attention to investor disclosures and compliance policies and procedures concerning the valuation of private fund assets.

The inherently unique and hard-to-value nature of these assets is well known, and many enforcement actions have involved a private fund's manipulation of portfolio assets to distort investor returns and/or increase fees.[9]

Level 3 assets, which make up a significant asset base for most private funds, are illiquid and require substantial valuation judgment by fund managers and compliance professionals; net asset values, or NAVs, will likely not be uniform across the private fund landscape.

Accordingly, the SEC will continue to closely evaluate all aspects of a fund's valuation policies and determinations, particularly given that exam staff has recently observed continued failures by funds to comply with their own valuation policies, to the detriment of investors.[10]

Private fund managers and compliance officers must thus be keenly aware of and regularly refer to their funds' valuation policies when marking NAVs for each portfolio asset, and confirm that those policies align with the methods disclosed to investors in the offering and partnership documents, particularly given the role valuations play in fee calculations.

Similarly, when a fund observes a market event that may affect portfolio assets, such as COVID-19 or dramatic shifts in energy prices, internal protocols should specifically provide a mechanism for prompt evaluation of NAV, and fund representatives should thoroughly document the reasoning behind adjusting or maintaining NAV.

Delays in adjusting the NAV of a particular asset or group of assets given obvious market impact can signal to regulators that the fund has not implemented sufficient valuation policies and procedures, or may be attempting to inflate fees by maintaining artificially high marks.

Waiver of Fiduciary Duties

Over 36% of SEC-registered investment advisers manage private funds and, therefore, owe a federal fiduciary duty to their clients, enforceable through the Investment Advisers Act.[11] Critically, this duty cannot be waived.[12]

Despite this, Gensler noted with concern that many general partners purport to seek waivers of their fiduciary duties to investors through partnership agreements or other disclosure vehicles.

Gensler's comments, paired with investors' increasing awareness, signal enhanced regulatory scrutiny of private funds' efforts to waive duties inherent in the advisory relationship.

In particular, private funds should exercise substantial caution when it comes to waiving conflicts of interest.

The SEC has previously advised that a fund's attempted waiver of all conflicts would be inconsistent with the Investment Advisers Act, and representations to investors that purport to allow the adviser to engage in conflicted transactions or practices without disclosure would likely run afoul of the adviser's fiduciary duty.

Investor complaints involving allegations that an adviser has breached its fiduciary duty are not uncommon, particularly where a fund's disclosures are limited, inconsistent, untimely or in conflict with previously provided information.

While many complaints do not credibly implicate an adviser's fiduciary duty, private funds would be well served to integrate clear, structured processes into their compliance programs to document such complaints.

This process should include consultation with relevant stakeholders and/or in-house counsel to determine the nature of the investor's dissatisfaction and identify fund representatives involved in the investor's account. The defined process should provide a basis for a prompt and thorough response.

It is possible, perhaps even likely, that the same investor may also alert enforcement authorities about its complaint; private funds should therefore take any such allegation seriously and respond with an eye toward managing a potential regulatory inquiry.

To the extent an applicable fund document includes full or limited waivers of fiduciary duties, responses to investors should not rely upon this language as a defense to the alleged misconduct, but should instead substantively address the investor's concerns.

Conclusion

As with nearly all aspects of private fund regulation and enforcement, compliance policies, procedures and personnel remain the foundation of a fund's ability to satisfy investors and government agencies.

Gensler's November comments underpin the SEC's ever-growing focus in enhancing transparency obligations for private funds.

Stakeholders should take this as a signal that boilerplate compliance practices may no longer be sufficient to address the continued concerns regulators have with the relationship between funds on the one hand and ordinary investors on the other through their participation in retirement and pension plans.

Fund advisers should consider the new year as an opportunity to evaluate the totality of their compliance regimes across their respective firms.

Substantively revisiting outdated policies and procedures and incorporating bespoke practices that address the SEC's stated concerns, while seizing the opportunity to elevate their compliance programs in a manner that clarifies internal processes for investors and plan decision makers, could create a competitive advantage.

Doing so may well make a fund's value proposition more appealing to institutional investors while simultaneously and proactively uncovering a compliance lapse.

Conversely, failure to engage in these efforts may place the fund, its advisers and management at risk for individual scrutiny and possibly liability, particularly in light of SEC Director of Enforcement Gurbir Grewal's recently announced intention to revive the SEC's use of officer and director bars. [13]

Gensler's clear announcement that the SEC will more closely scrutinize core aspects of fund management and compliance policies and procedures has given private funds a chance to move ahead of potential regulatory intervention.

As we begin 2022, funds that substantively address the implications of the SEC's announced priorities should realize substantial and long-lasting benefits.

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[1] SEC Division of Investment Management, Private Funds Statistics Fourth Calendar Quarter 2020, available at https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2020-q4.pdf.

[2] SEC Chair Gary Gensler Prepared Remarks at the Institutional Limited Partners Association Summit, November 10, 2021, available at https://www.sec.gov/news/speech/gensler-ilpa-20211110#_ftn3.

[3] SEC Chair Gary Gensler Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs, September 14, 2021, available at https://www.sec.gov/news/testimony/gensler-2021-09-14; see also SEC Chair Gary Gensler Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee, May 26, 2021, available at https://www.sec.gov/news/testimony/gensler-2021-05-26.

[4] Chair Gensler's November 10, 2021 ILPA Prepared Remarks.

[5] SEC April 2018 Risk Alert, "Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers," available at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[6] SEC June 2020 Risk Alert, "Observations from Examinations of Investment Advisers Managing Private Funds," available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

[7] PLI: Hedge Fund & Private Equity Enforcement & Regulatory Developments 2021 (September 28, 2021): Maurya C. Keating, Associate Regional Director, U.S. Securities & Exchange Commission, Division of Examinations/New York Regional Office.

[8] See In the Matter of Global Infrastructure Management, LLC, File No. 3-20683, December 20, 2021, available at https://www.sec.gov/litigation/admin/2021/ia-5930.pdf ($4.5 million settlement between SEC and investment adviser to private equity funds for violations of Investment Advisers Act arising out of false and misleading statements to investors and potential investors concerning fee offsets and failure to adequately implement policies and procedures to ensure proper accounting of fees and expenses).

[9] See, e.g., Sec. & Exch. Comm'n v. SBB Rsch. Grp., LLC , No. 19-CV-06473, 2020 WL 6075873 (N.D. Ill. Oct. 15, 2020); SEC Press Release, "SEC Obtains Receiver Over Florida Investment

Adviser Charged With Fraud", available at https://www.sec.gov/news/press-release/2020-110 (Sec. & Exch. Comm'n v. TCA Fund Mgmt. Group Corp., No. 20-21964 (S. D. Fl. May 12, 2020)).

[10] November 10, 2021 Risk Alert, "Division of Examinations Observations: Investment Advisers' Fee Calculations," available at https://www.sec.gov/files/exams-risk-alert-fee-calculations.pdf.

[11] SEC June 2020 Risk Alert.

[12] See "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Advisers Act Release 5248: "A contract provision purporting to waive the adviser's federal fiduciary duty generally, such as (i) a statement that the adviser will not act as a fiduciary, (ii) a blanket waiver of all conflicts of interest, or (iii) a waiver of any specific obligation under the Advisers Act, would be inconsistent with the Advisers Act, regardless of the sophistication of the client." Available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

[13] Remarks at SEC Speaks 2021, Gurbir Grewal, Director, Division of Enforcement, October 13, 2021, available at https://www.sec.gov/news/speech/grewal-sec-speaks-101321