ASSET MANAGEMENT INSIGHTS

INSIGHTS FROM THE BDO FINANCIAL SERVICES PRACTICE

INVESTMENT ADVISORS' FEES AND EXPENSES, CONFLICTS OF INTEREST REMAIN A HIGH CONCERN BASED ON A RECENT OCIE RISK ALERT

By Dale Thompson, Assurance Partner

In its examinations of registered investment advisors that manage private equity funds or hedge funds (collectively, private fund advisors), the SEC's Office of Compliance Inspections and Examinations (OCIE) continues to observe deficiencies related to nine areas of conflicts of interest and four areas of fees and expenses, which were detailed in a recent risk alert.[1] These observations have resulted in a range of actions, including enforcement actions, issuance of deficiency letters or no-comment letters.

FIDUCIARY DUTIES OF AN INVESTMENT ADVISOR

As a reminder, Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act") prohibits investment advisors from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. Further, an investment advisor is a fiduciary under the Advisers Act, which comprises both a duty of care and a duty of loyalty to its clients. The duty of loyalty requires that an advisor must not place their own interests ahead of their clients'. To meet its duty of loyalty, an advisor

1 See SEC Office of Compliance Inspections and Examinations Risk Alert, *Observations from Examinations of Investment Advisers Managing Private Funds* (June 23, 2020).

BDO'S ASSET MANAGEMENT PRACTICE

BDO's Asset Management practice provides assurance, tax and advisory services to asset management entities, comprising hedge, private equity and venture capital funds as well as regulated funds. The practice services over 600 advisors nationwide with funds ranging from start-up funds to those with billions of dollars under management.

must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. This means that an investment advisor must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment advisor—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict.

Additionally, Rule 206(4)-8 of the Advisers Act prohibits investment advisors to hedge funds, private equity funds and other private pooled investment vehicles (collectively "private funds") from making false or misleading statements to, or engaging in, fraudulent, deceptive or manipulative actions with respect to any investor or prospective investor in private funds they manage.

OCIE OBSERVATIONS

See the table below for further details on the observations and concerns noted in the risk alert on the failures to provide adequate disclosures related to the nine areas of conflicts and interest, as well as the four areas related to fees and expenses.

Conflicts of Interest Related to:	Matters not Disclosed or Inadequately Disclosed by Private Fund Advisors	Impact on Investors
Allocations of investments	▶ Preferential allocation of limited investment opportunities to certain clients or ▶ Allocation of securities at different prices or inequitable amounts among clients.	▶ Certain investors were deprived of limited investment opportunities. ▶ Certain investors paid more for investments, did not receive their equitable allocation of such investments, or were unaware of the allocation process.
Multiple clients investing in the same portfolio company	Clients invested in different levels of a capital structure (e.g., debt versus equity) of the same portfolio company.	Investors were deprived of important information related to conflicts associated with their investments, or were deprived of limited investments.
Financial relationships between investors or clients and the advisor	▶ Economic relationship between a private fund advisor and select investors or clients, such as initial seed investors. ▶ Arrangements where select investors have an economic interest in the private fund advisor, providing credit facilities or other financing to the advisor or its clients.	Other investors did not have important information related to conflicts associated with their investments.
Preferential liquidity rights	▶ Preferential liquidity terms offered to select investors through "side-letter" arrangements that established special terms, including preferential liquidity terms. ▶ Side-by-side vehicles or separately managed accounts (SMAs) that invested alongside the flagship fund, and such vehicles/SMAs had preferential liquidity terms.	Some investors were unaware of the potential harm that could be caused if the selected investors: ▶ Exercised the special terms granted by the side letters; or ▶ Redeemed their investments ahead of other investors, particularly in times of market dislocation where there is a greater likelihood of financial impact.
Private fund advisor holding interests in recommended investments	▶ Private fund advisors and/or their principals and employees had interests in investments recommended to clients, including preexisting ownership interests or other financial interests, such as referral fees or stock options.	Investors were deprived of important information related to conflicts associated with their investments.
Co-investments	▶ Failure to follow the allocation process for co-investment opportunities that was disclosed to clients. ▶ Agreements with certain investors to provide them with co-investment opportunities, but not to other investors.	Investors may have been misled as to how co-investments operate (e.g., investors may not have understood the scale of co-investments and the manner in which co-investment opportunities would be allocated among investors).

Conflicts of Interest Related to:	Matters not Disclosed or Inadequately Disclosed by Private Fund Advisors	Impact on Investors
Service providers	▶ Portfolio companies controlled by the private fund advisor's private fund clients entered into service agreements with entities controlled by the advisor, its affiliates or family members of principals. ▶ Private fund advisors that had other financial incentives for portfolio companies to use certain service providers, such as incentive payments from discount programs.	Investors were deprived of important information related to conflicts associated with their investments. *In some cases, private fund advisors did not have procedures in place to ensure that they followed their disclosures related to affiliated service providers. For example, advisors represented to investors that services provided to the private funds or portfolio companies by affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated third parties. However, the advisors did not have procedures or support to establish whether comparable services could be obtained from an unaffiliated third party on better terms, including at a lower cost.*
Fund restructurings[2]	▶ The purchasing of fund interests from investors at discounts during restructurings. ▶ Private fund advisors required potential purchasers of investor interests to agree to a stapled secondary transaction[3] or provide other economic benefits to the advisor without adequate communications.	Investors were not made aware of information related to the value of the fund interests or about the investor options during restructuring—potentially impacting decisions made by the investors.
Cross-transactions	▶ Private fund advisors established the price at which securities would be transferred between its client accounts (known as "cross-transactions").	Investors were deprived of important information related to conflicts associated with cross-transactions in a way that disadvantaged either the selling or purchasing client.

Fees and Expenses Related to:	Observation of Issues	Impact on Investors
Allocation	Private fund advisors: ▶ Allocated shared expenses, such as broken-deal, due diligence, annual meeting, consultants and insurance costs, among the advisor and its clients in a manner that was not consistent with disclosures to investors or policies and procedures; ▶ Charged private fund clients for expenses that were not permitted by the relevant fund operating agreements, such as advisor-related expenses like salaries of advisor personnel, compliance, regulatory filings and office expenses; ▶ Failed to comply with contractual limits on certain expenses that could be charged to investors, such as legal fees or placement agent fees; and ▶ Failed to follow their own travel and entertainment expense policies.	Certain investors overpaid expenses.

2 Fund restructurings are transactions where a private fund advisor arranges the sale of an existing private fund or the fund's portfolio to a purchaser. In a restructuring, the purchaser often offers the existing investors the option to sell their interests or roll their interests into a new, restructured private fund.

3 A "stapled secondary transaction" combines the purchase of a private fund portfolio with an agreement by the purchaser to commit capital to the advisor's future private fund.

Fees and Expenses Related to:	Observation of Issues	Impact on Investors
Operating partners	▶ The role and compensation of individuals that may provide services to the private fund or portfolio companies but who are not employees of the advisor (known as "operating partners") was not adequately disclosed.	▶ Investors potentially misled about who would bear the costs associated with these operating partners' services. ▶ Investors potentially overpaid expenses.
Valuation	▶ Private fund advisors did not value client assets in accordance with their valuation policies or in accordance with the disclosures to clients (such as that the investments would be valued in accordance with GAAP).	Clients being overcharged management fees and performance-based fees because such fees were based on inappropriately overvalued holdings.
Portfolio company fees[4] and fee offsets	Private fund advisors: ▶ Failed to apply or calculate management fee offsets in accordance with the disclosures; ▶ Incorrectly allocated portfolio company fees across fund clients, including private fund clients that paid no management fees; ▶ Failed to offset portfolio company fees paid to an affiliate of the advisor that were required to offset management fees; ▶ Did not have adequate policies and procedures to track the receipt of portfolio company fees, including compensation that their operating professionals may have received from portfolio companies; and ▶ Negotiated long-term monitoring agreements with portfolio companies they controlled and then accelerated the related monitoring fees upon the sale of the portfolio company, without adequate disclosure of the arrangement to investors.	Investors overpaid management fees.

BDO OBSERVATIONS

Investor protection is an important focus for the SEC, and private fund advisors must have their clients' best interests front and center. Private fund advisors should seek to eliminate or mitigate conflicts of interest and make full disclosures to their clients that are informative, which means specific and clear disclosures relating to conflicts of interest and fees and expenses. Additionally, private fund advisors must ensure that the fees and expenses a client is charged, or expected to be charged, are fair and reasonable. They must ensure that the basis for determining charges is sufficiently disclosed, and the fees and expenses are determined in a manner that is consistent and accurate with the disclosures. In light of these observations from the OCIE, it is essential that private fund advisors review and enhance their compliance programs immediately, including their practices and implementation of written policies and procedures relating to conflicts of interest and fees and expenses.

4 Monitoring / board / deal fees (collectively referred to as "Portfolio company fees").

ANOTHER COMPLIANCE ISSUE IN THE RISK ALERT: MNPI/CODE OF ETHICS

The risk alert also addressed policies and procedures relating to material non-public information (MNPI). Section 204A of the Advisers Act requires investment advisors to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the advisor or any of its associated persons. Advisers Act Rule 204A-1 ("Code of Ethics Rule") requires a registered investment advisor to adopt and maintain a code of ethics, which must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.

OCIE staff observed the following issues that appear to be deficiencies under Section 204A or the Code of Ethics Rule:

1. **Section 204A.** Advisors failed to address risks posed by their employees (i) interacting with insiders of publicly-traded companies, outside consultants arranged by "expert network" firms, or "value added investors" (e.g., corporate executives or financial professional investors that have information about investments; (ii) who could obtain MNPI through their ability to access office space or systems of the advisor or its affiliates that possessed MNPI; and (iii) who periodically had access to MNPI about issuers of public securities, for example, in connection with a private investment in public equity.
2. **Code of Ethics Rule.** Advisors failed to (i) enforce trading restrictions on securities that had been placed on the advisor's "restricted list" or did not have defined policies and procedures for adding securities to, or removing securities from, such lists; (ii) enforce requirements in their code of ethics policy relating to employees' receipt of gifts and entertainment from third parties; (iii) require "access persons" to submit transactions and holdings reports in a timely manner or to submit certain personal securities transactions for preclearance as required by their policies or the Code of Ethics Rule; and (iv) identify correctly certain individuals as access persons under their code of ethics for purposes of reviewing personal securities transactions.

CONTACTS:

KEITH MCGOWAN
Asset Management Industry Co-Leader, Assurance Partner
New York
212-885-8037 / kmcgowan@bdo.com

KEVIN BIANCHI
Asset Management Industry Co-Leader, Assurance Partner
San Francisco
415-490-3241 / kbianchi@bdo.com

DALE THOMPSON
Assurance Partner
New York
212-885-7318 / dthompson@bdo.com

People who know Asset Management, know BDO.
www.bdo.com