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Recent SEC Developments on Examination Deficiencies, Ransomware, Purchasing 144A Securities and the Form 13F Reporting Threshold

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SEC Risk Alert Cites Private Fund Adviser Examination Deficiencies

On June 23, the U.S. Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") issued a risk alert (the "Risk Alert") identifying deficiencies cited during examinations of private equity and hedge fund registered investment advisers ("private fund advisers" or "advisers"). The deficiencies fall into three general categories: (1) conflicts of interest; (2) fees and expenses; and (3) policies and procedures relating to material nonpublic information ("MNPI"), as outlined below.[1]

Over the past several years, we have observed a focus by OCIE on most of the issues identified in the Risk Alert in examinations of private fund advisers, as outlined in our annual Registered Adviser Seminar & CCO Summits and prior client alerts,[2] and the Risk Alert notes no new areas of focus. However, the Risk Alert contains a good laundry list of many areas cited in examinations and advisers should continue to focus on adequate disclosure and procedures related to these topics.

Conflicts of Interest

The Risk Alert identifies the following specific conflicts of interest that OCIE identified as inadequately disclosed to investors and/or not addressed under advisers' policies and procedures:

Affiliated service providers — "market" terms

- *Risk area:* Failure to implement policies and procedures to ensure that services provided to the private funds and/or portfolio companies by affiliates of the adviser were provided on "market" (or "arm's length") terms, consistent with representations made to investors.
- *Kirkland observations:* When statements are made to investors that services provided by the adviser or its affiliates will be on "arm's length," "market" or similar terms, OCIE regularly has scrutinized the sufficiency of adviser benchmarking efforts to substantiate such representations (e.g., similarity between actual and benchmarked services, number of sources surveyed and frequency of benchmarking), and supporting documentation.

Affiliated service providers — disclosure of conflicts

- *Risk area:* Portfolio company engagement of service providers that are controlled by the adviser or its affiliates or family members of the adviser's principals, and service providers that provide the adviser incentive payments from discount programs.
- *Kirkland observations:* OCIE has long focused on the adequacy of disclosure regarding the use of adviser-affiliated service providers and advisers' adherence to such disclosure in practice, including the types of services, types of compensation paid for services (e.g., fees, guaranteed retainers, portfolio company equity interests, etc.) and whether such compensation offsets fund management fees. More recently, OCIE has focused on disclosure and practices related to group purchasing and vendor discount programs where benefits are not shared with funds and/or portfolio companies.

Fund restructurings and secondaries

- *Risk area:* Conflicts related to "fund restructurings"[3] and "stapled secondary transactions,"[4] including (1) the value of fund interests and options presented to investors during restructurings and (2) advisers requiring a purchaser to agree to stapled commitments in connection with a secondary transaction, providing benefits to the adviser.
- *Kirkland observations:* OCIE has shown an interest in fund restructurings and secondary transactions for several years and appears to be looking for an industry-

signaling enforcement action in this area. OCIE examinations of advisers that have conducted these transactions often entail interviews and extensive document requests, with a focus on, among other topics: whether investors were provided a "status quo" option for existing investors; disclosure regarding material conflicts of interest including advisers' exploration of alternative liquidity options and advisers' economic interests in the transaction; the bid solicitation and portfolio valuation process; the allocation of fees and expenses, and the placement agent selection process.

Multiple clients investing in different levels of the capital structure of the same portfolio company

- *Risk area:* This practice, which is increasing in recent years, raises potential conflicts of interest particularly if a portfolio company experiences financial distress.
- *Kirkland observations:* OCIE generally expects robust disclosure by advisers that engage in this practice and the adoption of objective policies and procedures to address potential conflicts of interest, including actions to be taken in the event of financial distress of the portfolio company.

Cross-transactions

- *Risk area:* Purchases and sales of securities between clients, or "cross-transactions," which have the potential to be more or less advantageous to certain clients over other clients.
- *Kirkland observations:* As the number of cross-fund transactions increase, OCIE has focused on disclosure of potential conflicts of interest. Advisers should also consider whether investor or advisory committee approval and a third-party valuation and/or fairness opinion are appropriate.

Investment allocations

- *Risk area:*
  - Allocation of investment opportunities among the adviser's clients (including flagship funds, co-investment vehicles, other funds and separately managed accounts), including conflicts related to different fee structures or priority allocations of limited investment opportunities.
  - Allocation of co-investments to co-investment vehicles and other co-investors. For example, OCIE observed instances where advisers failed to follow the co-investment allocation process disclosed to investors or failed to disclose to all

investors the existence of agreements with certain investors to provide co-investment opportunities.

- *Kirkland observations:* The allocation of investment and co-investment opportunities has long been a focus of OCIE, and we have seen an increased number of related examination deficiency letter comments in recent years. While we have not seen an enforcement action for a *quid pro quo* allocation of investment or co-investment opportunities, we believe this is a potential area of future SEC enforcement where there is inadequate disclosure and/or deviation from existing policies and procedures.

Financial relationships with investors

- *Risk area:* Financial relationships between investors and the adviser, such as seed investors, or investors with an economic interest in the adviser that provide financing or other services to the adviser or its clients.
- *Kirkland observations:* OCIE has been interested in these types of relationships for several years, primarily focusing on the disclosure of related conflicts of interest and adherence to such disclosure in practice.

Transactions with advisers

- *Risk area:* Recommending investments in which the adviser or its affiliates have a pre-existing ownership or other economic interests.
- *Kirkland observations:* Aside from the inherent conflicts of interest in these types of transactions and the restriction in many private fund agreements of such fund investments, OCIE has long been focused on principal transactions without proper disclosure and prior investor consent as required under the Advisers Act. Because principal and agency cross transactions are subject to a strict liability standard, they can lead to easy enforcement cases for the SEC.[5] Following historical enforcement actions in the area, OCIE also regularly inquires into the existence of loans between advisers and clients.

Preferential investor rights

- *Risk area:* Agreements that establish special terms for certain investors (e.g., “side letters”) or side-by-side vehicles, including preferential liquidity rights (e.g., for liquid strategies in hedge funds).
- *Kirkland observations:* OCIE has been interested in these types of agreements for several years and regularly requests copies of all side letters during examinations.

Exams primarily focus on disclosure regarding the adviser's ability to grant special terms to certain investors and the disclosure to all investors of material terms actually provided to select investors in side letters.

Fees and Expenses

The Risk Alert identifies a number of common deficiencies relating to private fund fees and expenses, including:

Allocations

- *Risk Area:* Allocation of fees and expenses (such as broken-deal, due diligence, annual meeting, consultant, and insurance costs) among the adviser and its clients that were inconsistent with disclosures to investors and/or the adviser's policies and procedures.
- *Kirkland observations:* OCIE has long focused on fee and expense allocation issues, and has frequently required advisers to reimburse unauthorized and/or misallocated fees and expenses during examinations. The SEC has also brought several enforcement actions in this area (a trend which is likely to continue), including with respect to most of the practices described below.

Unauthorized expenses

- *Risk area:* Charges to private fund clients for expenses that were not permitted under the relevant fund operating agreements, such as adviser overhead (e.g., employee salaries) and compliance.
- *Kirkland observations:* As more advisers have engaged in the practice of allocating a portion of certain employee (e.g., non-investment personnel) salaries and similar "overhead" costs to funds and portfolio companies, OCIE has focused on both the adequacy of disclosure of such practices (including whether such costs offset fund management fees), as well as adherence to policies and procedures for tracking time and allocating such costs and robust supporting documentation.

Service provider expenses

- *Risk area:* Inadequate disclosure regarding the role and costs of service providers (e.g., "operating partners") that provide services to private funds and/or portfolio companies.

- *Kirkland observations:* While most advisers have implemented robust disclosure regarding such service providers in response to the SEC's attention over the last several years, OCIE continues to focus on whether advisers have adhered to such disclosure with respect to the types of compensation paid (e.g., fees, guaranteed retainers, portfolio company equity interests, etc.), the types of services provided and whether such compensation offsets fund management fees, as well as the accurate tracking and allocation of fees and expenses where the service provider provides services to both the adviser and its funds and/or portfolio companies or across funds.

Compliance with fee and expense provisions of governing documents

- *Risk area:*
  - Inaccurately accounting for fees earned by the adviser from portfolio companies (e.g., monitoring fees, board fees or transaction fees) for purposes of applying private fund management fee offsets, including allocation of such fees to private fund clients that paid no management fees.
  - Failure to comply with contractual limits on certain expenses that could be charged to investors.

- *Kirkland observations:* OCIE typically requests adviser and fund financial statements during examinations, and compares the accounting of additional fees (e.g., monitoring fees and transaction fees) against management fee offset provisions, and the accounting of expenses against expense limitation provisions (e.g., organizational expense caps) in fund governing documents. OCIE also has been critical of sharing of fees otherwise subject to management fee offset, particularly with parties not performing services for such fees (e.g., passive co-investors), and similarly has scrutinized the amount of fees applied to offset main fund management fees when the portfolio company paying the fees is owned by both fee and non-fee paying funds, to determine if the allocation methodology is disclosed to investors.

Travel and entertainment

- *Risk area:* Failure of private fund advisers to follow travel and entertainment expense policies.
- *Kirkland observations:* OCIE has long focused on whether particular travel, lodging, meal and entertainment expenses charged to a private fund are authorized in the fund's governing documents, related disclosure, as well as adherence to stated travel and entertainment policies. OCIE has a relatively low threshold for what it

considers to be "excessive" travel or entertainment expenses, and expenses in this area may be difficult to justify without detailed disclosure (e.g., charter or private travel).

Valuations

- *Risk area:* Failure to value client assets in accordance with valuation processes and/or disclosure to clients, which resulted in overcharging management fees and carried interest based on such valuations.
- *Kirkland observations:* While the impact of valuations on management fees is primarily an issue for hedge funds that charge management fees and performance-based compensation based on net asset value (including unrealized investments), we have observed an increasing number of valuation-related deficiency comments by OCIE in private equity adviser examinations, including with respect to valuation practices contrary to written policies and procedures, inadequate documentation of the rationale for using a particular comparable company input and valuation policies that lack written methodologies and key inputs and assumptions specific to different asset classes in which funds invest. We expect a continued focus on valuation practices in light of the market dislocation caused by COVID-19.

Receipt of accelerated monitoring fees from portfolio companies

- *Risk area:* These fees can be seen by regulators and investors as payment for services that ultimately were not provided.
- *Kirkland observations:* Most advisers have discontinued the practice of charging accelerated monitoring fees following several SEC enforcement actions in this area.

MNPI and Code of Ethics

The Risk Alert highlighted several deficiencies relating to advisers' code of ethics and MNPI-related[6] compliance, including:

MNPI controls

- Risk area:
    - Insufficient procedures to govern adviser employees' interactions with (i) insiders of publicly-traded companies, (ii) outside consultants arranged by "expert network" firms and/or (iii) "value added investors" (e.g., corporate executives or financial professional investors with information about investments).

    - Insufficient procedures to protect against risks posed by employees who could obtain MNPI through their ability to access office space and/or systems of the adviser or its affiliates, and by employees who periodically had access to MNPI about issuers in public securities (e.g., in connection with an investment in public securities or service as a board member of a public company).

- *Kirkland observations:* The SEC has recently brought several enforcement actions regarding the failure to establish and implement policies and procedures to prevent the misuse of MNPI, including where an adviser that had insider trading policies and procedures did not maintain adequate documentation of determining an adviser employee that served on a public company board did not have MNPI prior to purchasing shares in the company on behalf of a fund. A lack of policies and procedures, and documentation of the implementation thereof, has led to SEC scrutiny and enforcement activity even where no insider trading has occurred.

  As a reminder, although issues around MNPI most frequently arise in the context of publicly traded equities, MNPI and insider trading policies and procedures also apply to transactions in publicly traded debt securities and in private equity and debt securities.

Trading restrictions

- *Risk area:* Failures to enforce trading restrictions on restricted list securities, and a lack of procedures for updating restricted lists.
- *Kirkland observations:* Similar to its focus on implementation of policies and procedures regarding MNPI, OCIE has focused on failures to enforce restricted lists, and failure to add companies to restricted lists (e.g., when a fund is considering an investment in the company, or when an adviser employee serves on a public company board or otherwise interacts closely with a company such that they are exposed to MNPI).

Personal securities transactions

- *Risk area:* Failure to require timely submissions of personal securities trading reports and failures to otherwise submit personal securities transactions for preclearance.
- *Kirkland observations:* OCIE routinely requests documentation of compliance policy exceptions during examinations, which makes personal securities preclearance and reporting violations easy to identify. These violations frequently are cited in examination deficiency letters.

Access persons

- *Risk area:* Failure to identify certain individuals as “access persons” under the code of ethics.
- *Kirkland observations:* “Access person” is defined under the Advisers Act to include any supervised person of an adviser who has access to nonpublic information regarding a fund’s purchase or sale of securities, or who is involved in making investment recommendations to a fund or has access to such recommendations.[7] Although the definition is relatively narrow, OCIE has broadened its focus to include whether certain employees and related persons of advisers should be treated as access persons, including for example, administrative employees that have access to an investment professional’s email inbox and/or files, IT professionals and “operating partners” and similar consultants who share office space with the adviser, have access to the adviser’s computer network and/or sit in on meetings where fund investment activity is discussed.

Gifts and entertainment

- *Risk area:* Failure to enforce requirements regarding employee receipt of gifts and entertainment.
- *Kirkland observations:* OCIE has long focused on gifts and entertainment, and, as noted above, has a relatively low threshold for what it considers to be “excessive.” Therefore, advisers should expect a focus on whether various gift and entertainment items were pre-cleared or otherwise authorized and the documentation thereof.

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While there are no novel or new developments in this Risk Alert, it serves as a useful summary of items that are frequently cited in OCIE examinations of private fund advisers over recent years.

SEC Risk Alert Cites Ransomware Concerns

On July 10, the SEC issued a risk alert (the “Ransomware Risk Alert”) regarding its observation that ransomware[8] and related phishing attacks on SEC registrants including investment advisers, broker-dealers and investment companies and their service providers have become more prevalent and more sophisticated. The Ransomware Risk Alert lists a number of specific measures OCIE has observed SEC registrants use to enhance cybersecurity preparedness and address ransomware attacks, including incident response and resiliency policies, procedures and plans, operational resiliency, training programs, vulnerability scanning and patch management, access management and perimeter security, many of which were previously described in OCIE's January 27, 2020 Cybersecurity and Resiliency Observations report.[9] The Ransomware Risk Alert also encourages SEC registrants to monitor the cybersecurity alerts published by the Department of Homeland Security Cybersecurity and Infrastructure Security Agency.[10]

The Ransomware Risk Alert notably encourages SEC registrants to share the information in the alert with their service providers, particularly those that maintain client assets and records for SEC registrants. From time to time, OCIE also has inquired about investment advisers' initial and periodic due diligence of key service providers during investment adviser examinations, SEC registrants should consider documenting their service provider due diligence efforts, which can include periodically requesting and retaining documentation regarding service provider cybersecurity preparedness and infrastructure, and/or periodically asking service providers to complete cybersecurity due diligence questionnaires. In addition, because the Ransomware Risk Alert cites email phishing as a primary means of deploying ransomware, SEC registrants should consider including a segment on phishing risks and prevention in employee compliance training.

SEC Settles Enforcement Action with Adviser for Purchasing 144A Securities on Behalf of Non-QIB Clients

On July 16, the SEC settled enforcement proceedings with an adviser for failing to implement adequate procedures in connection with the purchase of Rule 144A securities by investors (including individuals) who did not meet the test for "qualified institutional buyer" (QIB) in Rule 144A under the Securities Act of 1933. Rule 144A allows for the resale of restricted securities initially sold in private placements to QIBs, which are designated institutions (e.g., a private fund) which generally own and invest at least $100 million in securities issued by non-affiliates. The adviser subject to the consent order had purchased over $660 million Rule 144A securities for 81 client accounts that were non-QIBs, including natural persons. The adviser settled with the SEC and agreed to a cease and desist and a $200,000 penalty.

Advisers to private funds should be careful in representing QIB status to purchase Rule 144A securities due to the often overlooked complexity of the QIB $100 million test, including (1) that securities of affiliates (e.g., controlled portfolio companies) and uncalled capital commitments must be excluded from the $100 million calculation, (2) private fund entities in a single fund family are not aggregated in calculating the QIB status of each fund, and (3) the $100 million must actually be invested in securities of non-affiliates at the time of representation.

SEC Proposes to Increase Form 13F Reporting Threshold

On July 10, the SEC proposed amendments to Rule 13f-1 under the Securities Exchange Act of 1934 and Form 13F to increase the reporting threshold for institutional investment managers ("managers") from $100 million to $3.5 billion (the "Proposal") in 13F securities.[11] Currently, managers that exercise investment discretion over non-controlling positions in certain public equity securities that have a fair market value on the last trading day of any month of at least $100 million must file a quarterly public report with the SEC on Form 13F disclosing such holdings during the following year. If the Proposal is adopted, a significant number of managers, including smaller managers and managers that do not invest significantly in public equity securities, such as most middle-market private equity sponsors, will no longer be required publicly to disclose their holdings of public equity securities on Form 13F.[12] The SEC estimates that approximately 4,500 of the roughly 5,000 current filers would no longer be required to file.

The SEC may modify certain aspects of the Proposal before it is adopted. Managers should continue to file Form 13F based on the current requirements until the SEC formally adopts any amendments.

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1. Notably absent from the Risk Alert was any reference to broker-dealer registration issues for private equity sponsors that receive transaction fees. While a number of private equity sponsors received SEC examination inquiries and/or deficiency comments related to such practice leading up to and shortly following the *Blackstreet Capital Management, LLC* enforcement action in June 2016, we have observed no cited deficiencies related to broker-dealer registration in several years, indicating that it may not be a focus of the SEC's current leadership. ↩

2. *See, e.g.,* the following *Kirkland Alerts*: 2020 Private Fund Manager Compliance Update: U.S. SEC/CFTC Filing Deadlines and SEC Examination Priorities, *Kirkland AIM* (Jan. 15, 2020); 2019 Year in Review: U.S. Private Fund Manager Regulation, *Kirkland AIM* (Jan. 31, 2020); and 2018 Review: SEC Continues Active Oversight of Registered Private Fund Managers, *Kirkland AIM* (Jan. 11, 2019). Please contact the Kirkland investment funds attorney with whom you regularly work for a copy of our most recent seminar materials and/or to discuss our SEC examination and enforcement experience related to these topics.↩

3. The Risk Alert defines fund restructurings as transactions where a private fund adviser 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.↩

4. The Risk Alert defines a "stapled secondary transaction" as the purchase of a private fund portfolio combined with an agreement by the purchaser to commit capital to the adviser's future private fund.↩

5. Advisers should be particularly aware of principal transaction issues in warehousing transactions and in sell-downs from one fund to another early in the life of a fund when the adviser or its principals may still own more than 25% of the fund. *See* SEC Risk Alert Cites Frequent Principal and Agency Cross Trading Issues for Advisers, *Kirkland AIM* (Sept. 12, 2019). ↩

6. The SEC staff consistently has demonstrated a willingness to pursue enforcement actions for failures to establish, implement and enforce policies and procedures reasonably designed to prevent the use of material nonpublic information as required under the Advisers Act, even without actual instances of insider trading.↩

7. *See* Advisers Act Rule 204A-1(e)(1).↩

8. The Ransomware Risk Alert defines ransomware as a type of malware designed to provide an unauthorized actor access to institutions' systems and to deny the institutions use of those systems until a ransom is paid. According to the Ransomware Risk Alert, the perpetrators behind these attacks also demand compensation to maintain the confidentiality of customer data.↩

9. *See* OCIE Issues Observations on Cybersecurity and Resiliency; Supreme Court Refuses to Hear FINRA Pay-to-Play Challenge, *Kirkland AIM* (Feb. 14, 2020). The SEC also shares cybersecurity resources and guidance on its "Spotlight on Cybersecurity" website. ↩

10. *See* https://us-cert.cisa.gov/ncas/alerts. These alerts highlight tactics and techniques used by certain hackers and key strategies to reduce cybersecurity vulnerability. ↩

11. Under the Proposal, the SEC would review reporting thresholds every five years and make adjustments as necessary. ↩

12. The Proposal would also (i) eliminate the ability of managers to omit small holdings from Form 13F filings and (ii) modify the process for seeking confidential treatment for securities information disclosed in Form 13F. ↩

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Suggested Reading

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- 14 February 2020 Kirkland AIM OCIE Issues Observations on Cybersecurity and Resiliency; Supreme Court Refuses to Hear FINRA Pay-to-Play Challenge