



## Legal Risk Management Tip November 2012

### PRIVATE FUND ADVISER UPDATES: THE NEW SEC PRESENCE EXAMINATION

As a result of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), the private fund industry is forever changed. The law eliminated the private adviser exemption to the Investment Advisers Act of 1940 (“Advisers Act”), subjecting previously exempt advisers to registration, regulatory oversight and examination by the SEC. Today, there are close to 4,000 SEC registered investment advisers that manage one or more private funds, with 34% of these newly registered since the passage of Dodd-Frank.<sup>1</sup>

Based on this influx of newly registered advisers, the Commission’s Office of Compliance Inspections and Examinations (“OCIE”) has launched a broad initiative to both educate private fund advisers about their compliance obligations and conduct initial examinations of such new private fund adviser registrants. As part of this initiative, OCIE released a letter last month that was sent to newly registered private fund advisers outlining its new “Presence Exam” initiative.<sup>2</sup> The letter provides new advisers with a general overview of OCIE’s National Exam Program (“NEP”) and calls attention to several “higher-risk areas of business and operations” that will be the focus of the presence examinations. A summary of some of the more notable areas are highlighted below.

#### **Presence Exam Initiative**

In a speech last May at the Private Equity International Private Fund Compliance Forum, Carlo V. Di Florio, Director of OCIE, explained the agency’s Presence Exam Initiative strategy as three-fold: “an initial phase of industry outreach and education, sharing [OCIE’s] expectations and perceptions of the highest risk areas,” followed by “coordinated examinations of a significant percentage of new registrants,” and culminating with the “publication of a series of ‘after-action’ reports on the broad issues, risks and themes identified” in those examinations.<sup>3</sup>

Through the issuance of its letter to newly registered advisers, OCIE is satisfying its industry outreach and education. Specifically, the letter includes information on the SEC’s risk-based examination area, and the following higher-risk areas for private fund advisers to be aware of and address accordingly.

#### **Conflicts of Interest**

During examinations, NEP staff will review whether a private fund adviser’s procedures and internal controls are effectively designed to identify, mitigate, and manage conflicts within the organization. Particular areas of focus may include allocation of investments, fees and expenses,

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<sup>1</sup> Speech by Carlo V. di Florio, Private Equity International Private Fund Compliance, May 2, 2012 (available at <http://sec.gov/news/speech/2012/spch050212c vd.htm>) (“di Florio Speech”).

<sup>2</sup> The letter is available on the SEC’s website at <http://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf>.

<sup>3</sup> di Florio Speech.

compensation arrangements and sources of revenue, employee outside business activities and personal securities trading. Deputy Director for OCIE, Norm Champ, recently reiterated this theme in a speech to the New York City Bar.<sup>4</sup> Champ emphasized the fiduciary relationship between the adviser and the fund and noted the importance of allocating investments fairly. Champ also highlighted the duty of advisers to funds to disclose material facts to investors, and provided specific examples of areas of conflict that must be disclosed, including failing to disclose receipt of additional commissions if the investor switches from one series of a fund to another and failing to disclose the investment of client funds in entities in which the advisers' principals have an interest.

Other areas of interest include conflicts involving side-by-side management, shifting certain expenses to a less favored fund, putting funds into both equity and debt of a company, which have conflicting interests, and vendor selection of a related party to the adviser.

### **Promotional Marketing of Private Funds**

Another examination focus involves review of the promotional marketing materials used by the private fund adviser to ensure that no false or misleading statements are made about the fund or its performance records. Examiners will also carefully review how the adviser is soliciting investors for the private funds they manage including the use of placement agents. Private fund advisers must “[r]eview marketing documents, client communications and questionnaire responses to ensure information is truthful, accurate and not misleading...”<sup>5</sup> This area will be subject to particularly close scrutiny with the impending repeal of the general advertising and solicitation ban and the certain proliferation of sales materials in the private fund industry that will result.

### **Custody Considerations and Safety of Client Assets**

Another central area of the NEP staff's focus will be on compliance with the Adviser Act's custody provisions, including the selection and review of independent audits performed on the private funds. Champ emphasized this point in his speech to the New York Bar, stating that “examiners may verify some or all of your assets” and provided notice to advisers that “the examination staff will reach out to third parties and possibly clients in this process.”<sup>6</sup>

### **Valuation**

Valuation continues to be a hot topic focus area during SEC examinations. NEP staff will carefully review the private fund adviser's valuation policies, and particularly the methodology used to value illiquid and hard to value instruments as well as the procedures used to calculate management and performance fees. In his speech di Florio noted that valuation processes must be “robust, fair and transparent.”<sup>7</sup>

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<sup>4</sup> Speech by Norm Champ, New York City Bar, May 11, 2012 (available at <http://sec.gov/news/speech/2012/spch051112nc.htm>.)

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> di Florio Speech.

## **Other High-Risk Areas**

Dependent on the private fund adviser's business model, other areas that may be a potential examination focus include review of the strategy employed for each fund in comparison with the private fund documents, management of inter-product conflicts created by the management of multiple funds, risks created by the various stages of the fund's life cycle, implementation of adequate processes to ensure compliance with the fund's agreements and formation documents, and finally, the "overall attitude of management towards the examination process, its compliance obligations, and towards risk management generally, compared to its peers"<sup>8</sup> (also known as the "culture of compliance").

## **Conclusion**

Given the heightened regulatory focus, advisers to private funds are well advised through the SEC's Presence Exam Initiative letter to take steps now to ensure their compliance programs are robust and address those higher risks noted by the NEP staff. During the final days of the fourth quarter, advisers to private funds should consider what, if any, actions should be taken to address potential gaps so that the organization is well-prepared prior to the SEC staff's arrival. For more information or for assistance in SEC examination preparedness, please contact Jacko Law Group, PC at (619) 298-2880 or email us at [info@jackolg.com](mailto:info@jackolg.com). Thank you.

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<sup>8</sup> *Id.*