

CLIENT ALERT

Investment Fund Managers Are Again Reminded by SEC to Review and Fix Documentation, Policies, and Procedures

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On May 13, 2015, Marc Wyatt, Acting Director, SEC Office of Compliance Inspections and Examinations (OCIE), delivered an important speech that highlighted legal and compliance topics for investment fund managers.

Three takeaways:

1. **Expenses and Expense Allocation** – Historically, the SEC seemed to believe that investors in private investment partnerships (hedge funds, private equity funds, venture capital funds, etc.) were sufficiently wealthy to protect their own interests. In recent years, though, OCIE has scrutinized expenses charged by investment fund managers to their limited partners/the partnership. There have been high profile enforcement actions within the past year. Mr. Wyatt's speech again emphasized the SEC's focus. Not only should the terms in limited partnership agreements spell out, in detail, those expenses borne by the general partner (SG&A and other categories) and those by the partnership, but the fund manager has to ensure that expenses passed along to limited partners are consistent with their overall fiduciary duty. Since many managers have different investment strategies, customizing terms is the key, and Mr. Wyatt suggests that it may be appropriate for fund managers to amend their agreements (potentially with consent of the limited partners).

In our view, once a manager decides substantively those expenses that it will bear and those that the partnership will bear, it is important to make full and proper disclosure. Sponsors should pay particular attention to limited partnership agreements, private placement memoranda, marketing materials, communications to limited partners and prospective partners, and any other external content to ensure proper disclosure of expenses and allocations. Additionally, sponsors should consider whether responses to Part 2A of Form ADV should be revisited, keeping in mind Mr. Wyatt's caution that amending Part 2A is "usually not a sufficient remedy for absence of disclosure prior to fund closing."

2. **Co-Investment Allocation** – A key marketing theme, for many managers, is the opportunity for limited partners to co-invest. Mr. Wyatt's speech brings sunlight to the fairness of co-investment allocations, and suggests there have been undisclosed side arrangements by many managers. While not identifying any particular sponsors in the speech, Mr. Wyatt pointed out situations in which certain limited partners had preferred rights that had not generally been disclosed. Managers are encouraged to think about the economics of co-investments (management fees, expenses, carry) and participation rights, and then to make proper and full disclosure in documentation.
3. **Special Note to Real Estate Advisers** – Mr. Wyatt's speech was notable for the detailed focus given to private equity real estate advisers. OCIE is scrutinizing vertically-integrated real estate advisers for charge backs of the cost of employees who provide asset management services and for in-house attorneys. OCIE discovered that such fees have not been

disclosed in some cases. In other cases, such fees were disclosed with a representation to investors that such fees would be at or below a market rate. OCIE wants to examine documentation that such charge backs are in fact at or below market, and, in the examinations to date, OCIE "rarely saw that the vertically integrated manager was able to substantiate claims that such fees are 'at market or lower.'" Fund sponsors that make such representations should be prepared to show examiners appropriate and documented benchmarks.

Mr. Wyatt closed with an ominous note on a potential slackening in fiduciary responsibilities given the current state of the business cycle: "Current levels of dry powder and transaction multiples make me worry that, at some point, the markets will start to recede and that the outgoing tide may reveal disturbing practices which will need to be addressed. Issues such as zombie advisers and fund restructurings may again come to the fore as we move through the business cycle." In other words, OCIE will continue to focus on sponsors who are, in staff's view, inappropriately managing funds for the sake of accumulating fees.

OCIE has significantly bolstered its examination prowess. When OCIE knocks, fund sponsors should expect a thorough examination and should be prepared in advance. We strongly encourage clients to conduct internal "mini-examinations." Compliance consultants (retained by counsel) and /or counsel can be skillfully employed on a routine basis ahead of OCIE exams.

The full text of the speech [may be found here](#).

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.