



Morgan Lewis

**COMMON DEFICIENCIES
IN EXAMINATIONS OF**

PRIVATE FUND ADVISERS

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Presenters



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Risk Alert: Overview of Common Deficiencies

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Conflicts of Interest Disclosure

- An investment adviser's fiduciary duty to eliminate or make full and fair disclosure of all conflicts of interest

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Fees and Expenses

- Allocation issues
- Calculation issues
- Disclosure issues

3

Compliance Policies

- MNPI/Compliance Manual
- Code of Ethics

Conflicts of Interest

Disclosure Deficiencies

Allocation of Investments

- Preferential access to limited capacity investments for flagship funds, new clients, higher fee-paying clients, SMAs, co-investment vehicles, CLO funds, sub-advised mutual funds, proprietary accounts, and proprietary-controlled clients
- Allocations to multiple clients at different prices
- Deviation from investment allocation processes

Multiple Clients Investing in the Same Company

- Different clients investing in different levels of a portfolio company's capital structure may have competing interests

Considerations

Allocation of Investments

- Does the firm have an incentive to allocate investment opportunities to certain funds or SMAs based on fee rates, size of a client, or other interests related to a specific client or investor?
- Are these incentives adequately disclosed in fund governing documentation and PPMs, as well as the firm's Form ADV Part 2A brochure?
- Does the firm adhere to its investment allocation processes?

Multiple Clients Investing in the Same Company

- Do new funds that provide follow-on or co-investment capital to a portfolio company compete with existing funds for investment opportunities, dilute existing fund interests, or invest in more senior parts of the company's capital structure?

Conflicts of Interest

Disclosure Deficiencies

Relationships between Investors and Adviser

- The presence of preexisting economic relationships with clients/investors (e.g. investors providing seed capital for a fund, or clients providing credit facilities or other financing for the adviser or other clients).

Relationships with Service Providers

- Selection of vendors for which the adviser receives a financial incentive (e.g. incentive payments from discount programs)
- Service provider was a controlled affiliate of the adviser or a family member of a principal

Considerations

Relationships between Investors and Adviser

- Does the firm have any special economic relationships with investors or SMA clients?
- Are these relationships adequately disclosed to clients in fund PPMs and the firm's Form ADV Part 2A brochure?

Relationships with Service Providers

- Does the firm have a financial or other incentive to use one service provider over others?
- Are there instances where the exclusive use of a service provider (including affiliates) would not be in a client's best interests?
- Are the incentives and disadvantages to using a certain service provider adequately disclosed to clients in fund PPMs and the firm's Form ADV Part 2A brochure?

Conflicts of Interest

Disclosure Deficiencies

Adviser Interests in Recommended Investments

- Advisers or their principals/employees with preexisting ownership or financial interests in investments they recommend (e.g. referral fees and stock options)

Preferential Rights for Certain Clients/Investors

- Preferential liquidity terms and other special benefits provided to certain fund investors through side letters
- Preferential liquidity provided to certain SMAs and parallel funds investing side-by-side with other funds/clients that are not afforded such benefit

Considerations

Adviser Interests in Recommended Investments

- Does the firm have any proprietary interests in the investments in which it advises its funds and other clients to invest?
- Are the firm's principals or employees able to recommend an investment to a client in which such principals/employees have personally invested?

Preferential Rights for Certain Clients/Investors

- Do any side letters, SMA agreements, or parallel fund documents afford investors preferential liquidity?
- Market dislocation can increase redemption requests and intensify preferential liquidity concerns. Advisers may also be more inclined to offer preferential rights in difficult fundraising environments.

Conflicts of Interest

Disclosure Deficiencies

Fund Restructurings

- When conducting a “GP-led” restructuring of a fund, disclosure of the value of fund interests or the presence of a benefit to the adviser (e.g. stapled secondary transaction)

Cross-Transactions

- In purchases and sales of between clients, disclosure of how the transfer price is calculated, or how the price potentially disadvantages one party to the transaction

Considerations

Fund Restructurings

- When conducting “GP-led” secondary transactions does the firm:
 - obtain independent valuations to support the price, or acquire advisory committee or investor approval of the price?
 - disclose the material terms, risks, and conflicts of interest including information on the bids received, the auction process, how the price was determined, any status quo option or changes to fund terms, “staple” investment requirements, the extent to which existing investors may be diluted, and the terms of the preferred equity class (if applicable)?

Cross-Transactions

- When advising a fund or other client during a transfer of interests, does the firm disclose pricing methodologies, as well as associated benefits to the firm, its affiliates, and principals/employees?

Fees and Expenses

Deficiencies

Allocation of Fees and Expenses

- Inconsistencies between disclosures and allocation policies, as well as travel and entertainment expense policies
- Compliance with contractual limits
- Overcharging of shared expenses (e.g. broken-deal, due diligence, annual meeting, consultant, and insurance costs)
- Overcharging of adviser-related expenses (e.g. salaries of adviser personnel, compliance costs, regulatory filings, and office expenses)

Operating Partners

- Disclosure of the role, compensation, and costs associated with “operating partners” who provide services to portfolio companies

Considerations

Allocation of Fees and Expenses

- Are fees and expenses allocated to funds and SMA clients consistently with firm policies and procedures?
- Are fees and expenses allocated to clients consistently with disclosures in fund governing documents, private placement memoranda, client agreements, and the firm’s Form ADV brochure?
- In “GP-led” secondary transactions, does the firm disclose how deal expenses are allocated or if any fees or other economic benefit is paid to the firm?

Operating Partners

- Does the firm disclose the role, compensation, and costs associated with “operating partners”?

Fees and Expenses

Deficiencies

Valuation

- Inconsistencies between the value of client assets and firm valuation processes
- Overcharging management and performance fees/carried interest based on overvalued holdings

Deal Fees and Offsets

- Calculating or applying portfolio company fees to offset fund management fees inconsistently with fund disclosures
- Inadequate policies to track portfolio company fees
- Lack of disclosure concerning the acceleration of long-term monitoring fees on the sale of portfolio companies

Considerations

Valuation

- Are client assets accurately valued in accordance with the firm's policies and procedures to avoid inadvertently overcharging management fees and performance fees/carried interests on overvalued assets?
- Are client assets valued in accordance with the firm's disclosures in fund governing documentation and other disclosures?
- During market dislocation, accurate valuations may be especially difficult to determine due to extraordinary market volatility.

Deal Fees and Fee Offsets

- Are portfolio company fees calculated and applied to fund management fees in accordance with firm policies?
- Does the firm adhere to its expense allocation procedures with respect to whether investors will bear broken-deal costs?

Compliance Policies

Deficiencies

MNPI/Compliance Manual

- Policies and procedures inadequately address risks posed by employees interacting with third parties that may possess MNPI (e.g. insiders of publicly traded companies, outside consultants from “expert network” firms, and “value-added investors”)
- Policies and procedures inadequately address risks posed by physical access to office spaces or systems possessing MNPI
- Inadequate processes for maintaining and updating restricted lists

Code of Ethics

- Inaccurate assessment of which individuals should be deemed “access persons” under the firm’s Code of Ethics
- Inadequate processes relating to personal securities reporting requirements for “access persons”
- Failure to enforce Code of Ethics requirements relating to employees’ receipt of gifts and entertainment from third parties

Considerations

MNPI/Compliance Manual

- Does the firm have adequate processes to monitor employee interactions with third parties possessing MNPI (e.g. does the firm have/need a policy regarding the use of expert networks?)
- Does the firm’s restricted list capture, in a timely manner, all securities for which supervised persons may possess MNPI?

Code of Ethics

- Are all persons within the “access person” definition subject to the firm’s Code of Ethics?
- Does the firm effectively obtain transaction reports, holdings reports, and trade pre-clearances in accordance with the Code of Ethics Rule under the Advisers Act?
- Does the firm properly enforce the disclosure obligations and prohibitions of its gifts and entertainment policy?

COVID-19 - OCIE Risk Alert

On August 12, OCIE published a Risk Alert highlighting select COVID-19 compliance considerations for investment advisers and broker-dealers. The following are relevant to private fund advisers.

Protection of Assets

- Custody Rule concerns for safeguarding investor assets against theft, loss, and misappropriation, particularly when personnel cannot access mail at the office

Supervision

- Concerns over supervisors' ability to surveil and interact with supervised persons working remotely
- Limitations to conducting onsite due diligence reviews of third-party managers and companies

Fees, Expenses, and Financial Conflicts

- Borrowing from clients in times of financial distress
- Over-billing advisory fees due to increases in fee calculation or asset valuation errors

Investment Fraud

- Times of crisis/uncertainty create heightened risk of investment fraud
- Importance of due diligence and determining investments are in the best interests of investors

Business Continuity

- Risks related to remote operations, including remote site and facility security
- Concerns regarding key operations, key person succession plans, and mission critical services

Information Security

- Vulnerabilities around the potential loss of personally identifiable information attributed to remote network access, increased use of personal devices, and sensitive documents printed remotely
- Increased cyberattacks and phishing attempts

Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

Morgan Lewis

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at www.morganlewis.com/topics/coronavirus-covid-19

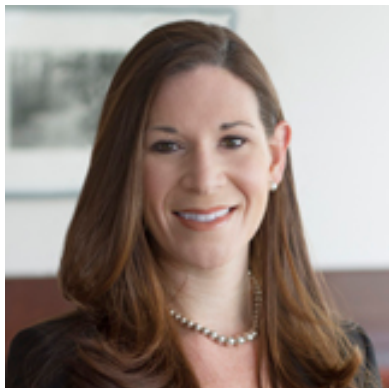
If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple "Stay Up to Date" button.



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Christine Lombardo advises investment managers and broker-dealers on financial regulatory matters. She concentrates her practice on securities regulation for a broad range of financial firms including retail asset managers, private fund managers, family offices, broker-dealers, other professional traders, and high-net-worth individuals. Christine also counsels legal, compliance, and business personnel on the structure, operation, and distribution of advisory programs, including digital advisory offerings, and investment products, including hedge funds, private equity funds, venture capital funds, real estate funds, and other alternative investment products.

Christine also counsels financial firms through examinations by industry regulators, as well as on enforcement related matters. Before joining Morgan Lewis, she was an associate at an international law firm in New York and worked for the Division of Enforcement at FINRA.

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Joseph D. Zargari focuses on the private investment fund industry, including the structuring, formation, governance, and regulation of and investment in US and non-US hedge funds, private equity funds, venture capital funds, managed accounts, and other products. In addition, Joe has a significant practice representing buyers, sellers, and general partners in secondary transactions (including portfolio sales of fund interests and GP-led transactions). He also provides legal, regulatory, and transactional advice for investment managers and institutional investors. Joe is the practice group leader for the New York office investment management practice.

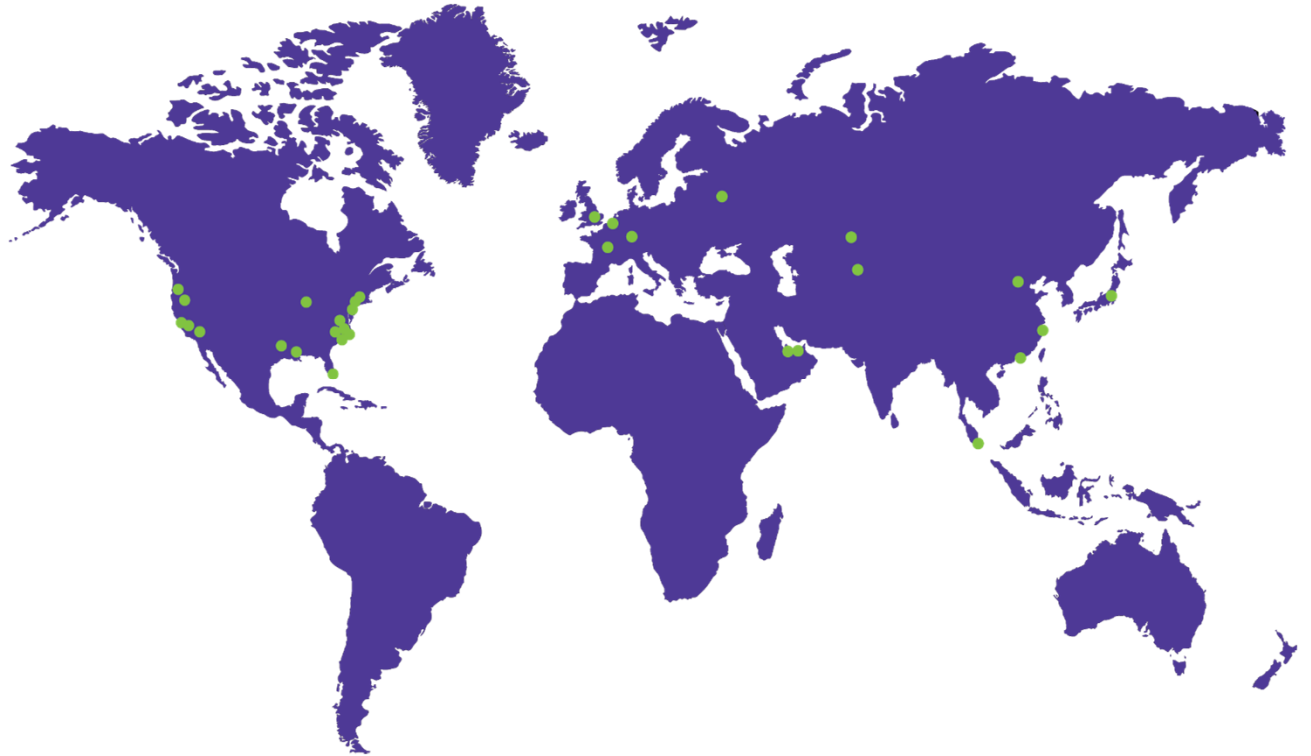
Actively engaged in all aspects of the private funds practice, Joe's experience covers all types of private investment funds, including hedge funds, private equity funds, venture capital funds, secondary funds, real estate funds, credit funds, infrastructure funds, energy funds, funds of funds, hybrid funds, and funds of one. He counsels sponsors through all stages of product development and capital raising, including management company and fund formation, placement agent agreements, seed and lead investor arrangements, regulatory and compliance issues, and investment activities (including direct investments and co-investments). He also advises funds of funds, pension plans, endowments, family offices, and other institutions in connection with their investments in private funds.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
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