# FUNDS, FEES & AFFILIATES (OH MY!)

## SEC OCIE's Examination of the Private Fund World

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Presenters:
Matthew D. Harris, Securities Exchange Commission, Chicago Office
Edward Schwartz, ORG Portfolio Management

NAPPA SEC Working Group Panel
2015 NAPPA Legal Education Conference
June 25, 2015

# Agenda

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|---|---|---|
| **I.** | **Overview** | Marc Lieberman |
| **II.** | **OCIE Examinations** | Matthew Harris |
| | A. Examination Process | |
| | B. Exam Priorities | |
| | C. Examination Results | |
| **III.** | **Panel Discussion** | Jim Van Horn<br>Marc Lieberman |
| | A. Fee Allocations, Disclosure & Transparency | Matt Harris |
| | B. Fiduciary Duty of Private Fund Advisers | Ed Schwartz |
| | C. Role of Fund Administrators & Auditors | |
| | D. Independent Monitors | |
| **IV.** | **Questions** | |

# Overview

- Increased Federal Oversight of Private Investment Funds
  - 2010 – Dodd-Frank Act amends Investment Advisers Act of 1940 (Advisers Act) - Private Fund Advisers (PFAs) must register with SEC
  - June 2011 – SEC Adopts Rules - PFAs ≥ $150 mm to register
  - Oct. 9, 2012 – OCIE Letter to PFAs announcing "Presence Exams"
  - May 2, 2012 – OCIE Director di Florio Speech – PFA Compliance with Advisers Act

# OVERVIEW

- Increased Federal Oversight of Private Investment Funds
  - May 11, 2012 – OCIE Director Champ Speech - "What SEC Registration Means for Hedge Fund Advisers"
  - January 9, 2014 – OCIE /NEP Examination Priorities for 2014 (PFAs prioritized)
  - January 28, 2014 – OCIE "Risk Alert" re: investor due diligence of PFAs
  - May 6, 2014 – OCIE Director Bowden, "Spreading Sunshine in Private Equity"
  - January 13, 2015 – OCIE/NEP Examination Priorities for 2015 (PFAs prioritized)

# OVERVIEW

- SEC Divisions and Working Groups Focused on PFAs
  - Division of Investment Management
  - Division of Enforcement: Asset Management Unit
  - OCIE: Private Fund Specialized Working Group

# OCIE Examinations 2015

- PFAs subject to the Advisers Act and adopted SEC Rules
- All PFAs must have the following:
  - Written compliance policies & procedures and a CCO
  - Current, complete, accurate and true books and records
  - Code of ethics establishing standards of conduct for staff
  - No false or misleading advertising or advertising that contains untrue statements of material fact
  - Custody Rule compliant procedures

# OCIE Examinations 2015

- RIAs are fiduciaries under the Advisers Act
  - Obligation to act in the best interests of their clients and provide investment advice in their client's best interest
  - Owe a duty of loyalty and good faith

# OCIE Focus for 2015

- Practices/Products presenting heightened risk to investors (e.g., alternative investments)
- Investigative Targets
  - Conflicts of Interest
  - Deceptive Marketing

# Conflicts of Interest

# Conflicts of Interest

- Particular focus on:
  - Undisclosed/unfair compensation arrangements
    - Hidden fees and compensation
    - Failure to apply fee offsets correctly
    - "Market" expenses far greater than market
    - Undisclosed affiliations

# Conflicts of Interest

- Particular focus on:
  - Misallocation of investment opportunities
    - Favoring insiders/high commitment investors
    - Favoring predecessor/successor funds/investors

# Camelot Acquisitions

*Private Equity Firm Founder Takes Plea Deal in $9.3M Theft Case*

The founder of a New York private equity firm took a plea deal for stealing $9.3 million from investors and spending it on jewelry, a luxury car and rent.

West Point grad Lawrence Penn III copped to grand larceny and falsifying business records in exchange for 2 to 6 years in prison. He must also make restitution of $8.3 million and relinquish his company's interest in the fund.

# Camelot Acquisitions

*Private Equity Firm Founder Takes Plea Deal in $9.3M Theft Case*

Penn allegedly siphoned cash from Camelot Acquisitions to shell a company set up by his pal Michael Ewers – who also pleaded guilty for his role in the scheme that ran from 2010 to 2013.

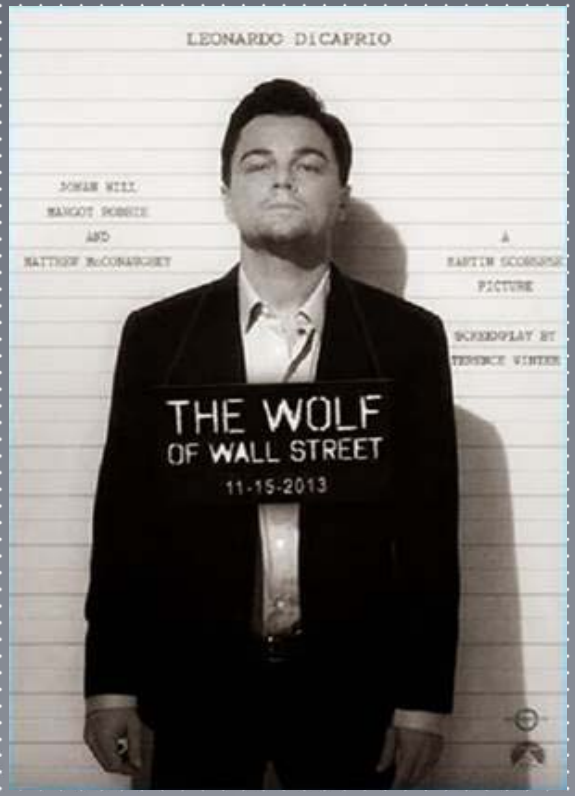
The diverted cash was made to look like payments for Ewer's services but actually served as a front, prosecutors said.

# Deceptive Marketing

*BlackRock to Pay $12 Million Penalty for Failing to Disclose Conflict of Interest*

BlackRock agreed to pay the SEC $12 million to settle allegations that it failed to inform clients about a conflict between a fund manager's private holdings and portfolios he supervised for BlackRock clients.

# Deceptive Marketing



# DECEPTIVE MARKETING

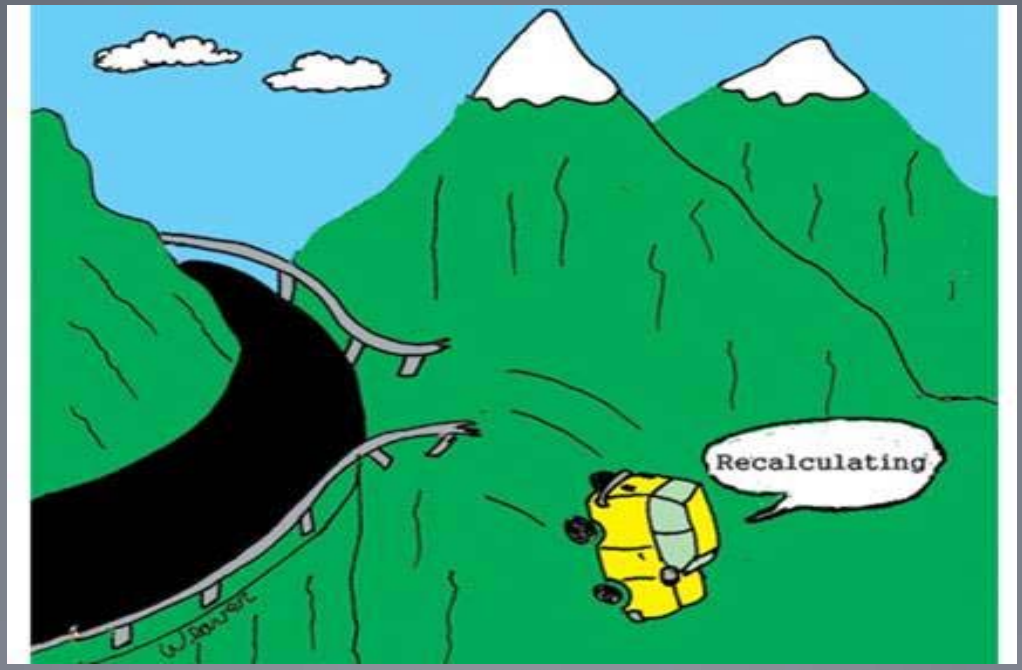
- F-Squared Prosecution
  - Fund advertised a successful 7-year track record with strategy that didn't exist during the specified period.
  - F-Squared agreed to retain an independent "compliance consultant" [plus pay $35 mm]
  - Take Away: Laser focus on "facts" alleged in marketing materials, including Asset Valuations and Returns

# VALUATION

- Heightened investigation of valuation procedures and techniques
  - Targets
    - Hypothetical returns
    - False performance figures
    - False assurances about how value is ascertained
    - Improper valuation techniques
    - Use of friendly "broker marks"

# MISCELLANEOUS CONCERNS

- Focus on funds deviating from investment guidelines or pursuing undisclosed strategies

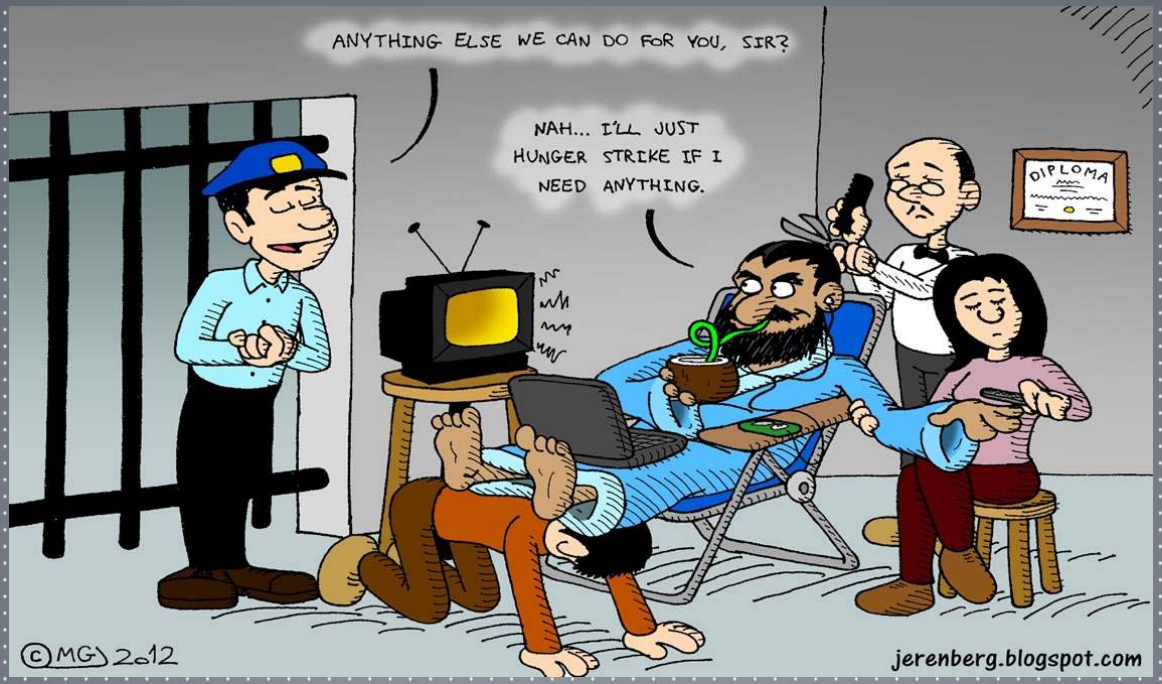


# Miscellaneous concerns

- Accuracy of fund distributions

# Miscellaneous concerns

- Accuracy of fund governance



# TRENDS

- Increased use of Independent Compliance Monitors or Fee Monitors

*Should we demand them?*

# TRENDS

- Increased Disclosures/Compliance Procedures

*Theoretically, heightened SEC scrutiny should lead to a decrease in fraud, but will it?*

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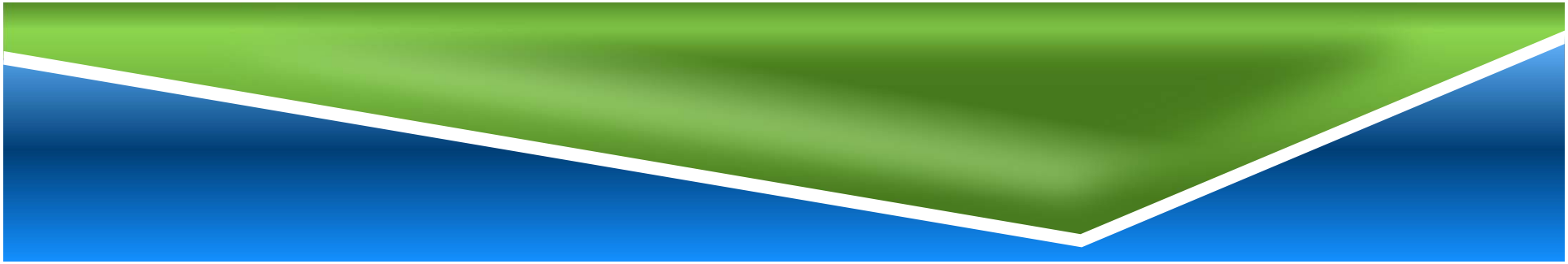
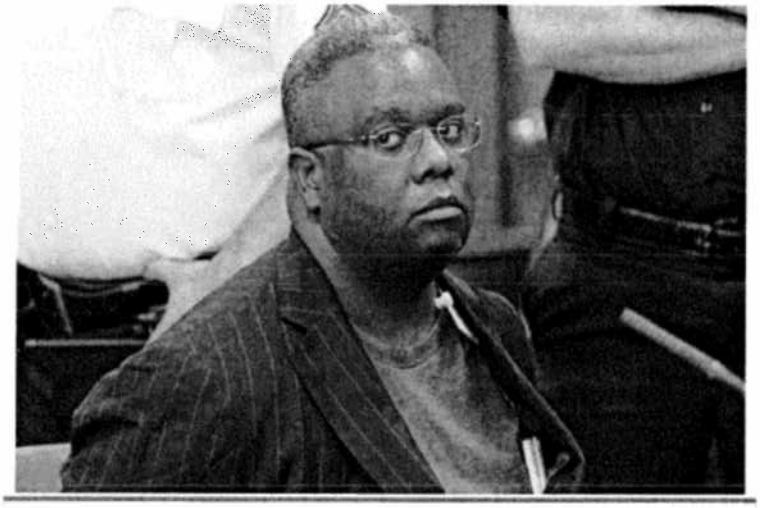


METRO

# Private equity firm founder takes plea deal in $9.3M theft case

By Rebecca Rosenberg March 16, 2015 | 12:15pm



Lawrence Penn III
Photo: Steven Hirsch

The founder of a New York private equity firm took a plea deal Monday for stealing $9.3 million from investors and spending it on jewelry, a luxury car and rent.

West Point grad Lawrence Penn III copped to grand larceny and falsifying business records in exchange for 2 to 6 years in prison. He must also make restitution of $8.3 million and relinquish his company's interest in the fund.

Justice Laura Ward offered the deal over the objections of prosecutors. Assistant District Attorney Chevon Walker recommended 4 to 12 years in prison. He's already served more than a year of his sentence.

Penn allegedly siphoned cash from Camelot Acquisitions to a shell company set up by his pal Michael Ewers – who also pleaded guilty for his role in the scheme that ran from 2010 to 2013.

The diverted cash was made to look like payments for Ewer's services but actually served as a front, prosecutors said.

Penn, 45, allegedly used the stolen loot for credit card payments, cash withdrawals, luxurious office space, rent for two apartments, jewelry and even a fancy car.

"Under the circumstances it's a very fair disposition and I commend Judge Ward for having the independence to impose a sentence substantially below what the District Attorney was asking for," said defense lawyer Ben Brafman. "I think it's appropriate given my client's sterling record before this incident."

FILED UNDER CRIME, LAWRENCE PENN III, PERSONAL FINANCE, PLEA DEALS

**Shots fired at NYPD officers**



## COLUMNISTS

Fredric U. Dicker

**Democrats favor Martin O'Malley for president if Hillary doesn't run**

Michael Goodwin

**De Blasio allowing city to trickle back to bad old 'Taxi Driver' days**

Andrea Peyser

**I don't regret my office romance – and neither should you**

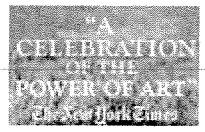
SEE ALL COLUMNISTS

## TRENDING NOW IN METRO

**Crowd-funders want to boot 'beach babies' out of NYC after blast**

10202

The New York Times http://nyti.ms/1vArF80




BUSINESS DAY

# Entering the Secret Garden of Private Equity

By GRETCHEN MORGENSON DEC. 27, 2014

Is private equity about to get a little less private?

Perhaps so, judging by the decision of a venerable private equity firm to allow investors in one of its funds to hire an independent adviser to monitor the fund's practices. Beyond reviewing the books and financial records at the fund, the outside adviser would also be permitted to scrutinize the fund's governance practices for conflicts of interest, the firm said.

This shift in practice, which has not been previously reported, was disclosed to investors in June by Freeman Spogli & Company, a $4 billion private equity firm created more than 30 years ago, in a letter laced with legal jargon that obscured the import of the decision.

The new policy applied to the firm's newest fund: FS Equity Partners VII, which opened for investment this year and has closed with $1.3 billion in committed funds. Investors in that fund include pension funds and public investments, such as the Kansas Public Employees Retirement System, the New Mexico State Investment Council and the New York State Common Retirement Fund.

Freeman Spogli, according to its website, typically invests in medium-size consumer and distribution businesses. Its current investments include Petco, the pet supplies retailer; Boot Barn, a chain of Western wear stores; and Totes Isotoner, the maker of umbrellas, boots and accessories. Ronald P. Spogli, co-founder of the firm, was ambassador to Italy under President George W. Bush.

Allowing the appointment of a monitor is no small matter. Giving an outsider routine access to internal fund operations is practically unknown in the $3.5 trillion private equity industry, where powerful firms operate in near secrecy and hold so much sway that many investors say they feel fortunate to be allowed to put money into the funds. The independent adviser will report to the fund's investors.

Karl Olson is a partner at Ram, Olson, Cereghino & Kopczynski who has sued the California Public Employees' Retirement System, known as Calpers, to force it to disclose fees paid to hedge fund, venture capital and private equity managers. He said he had never seen a provision allowing an independent monitor at a private equity fund.

"It does seem like a step in the right direction because too often the limited partners are unduly passive," he said, referring to investors. "They should feel they are in the driver's seat and that they have an obligation to drive a hard bargain with the funds."Phone calls seeking comment at both the New York and Los Angeles offices of Freeman Spogli were not returned.

Freeman Spogli may not have acted out of the goodness of its heart. Documents obtained by The New York Times show that the independent adviser appointment was disclosed after officials at the Securities and Exchange Commission raised questions about several of the firm's practices. Those questions arose from an examination in April 2013 related to two older Freeman Spogli funds and were posed in a private letter that the S.E.C. sent to the firm in May 2013.

According to the letter, S.E.C. officials said that Freeman Spogli appeared to be violating fee-sharing arrangements with its investors in two funds, despite promises to the contrary. And Freeman Spogli, the S.E.C.'s letter said, appeared to be reaping fees from investment-banking-type transactions without fulfilling the regulatory requirement of being registered as a broker-dealer.

Private equity firms use borrowed money to acquire companies that they hope to resell at a profit. It is no secret that fees charged to investors in private equity funds are high. Many investors view those fees as the cost of entry into a hot investment arena.

This year, the problem of hidden and possibly abusive fees at these funds has been brought to light in several articles in The Times. Many investors, for example, did not know that private equity firms could charge fees for monitoring an investment even after it had been sold. Neither did most investors realize that they were responsible for the payment of legal settlements if private equity executives were accused of wrongdoing. One reason investors are often in the dark in these matters is that the terms of the agreements they strike with the private equity firms are kept confidential, even from beneficiaries.

The S.E.C. declined to comment on the Freeman Spogli situation specifically, but Drew Bowden, director of the S.E.C.'s office of compliance inspections and examinations, said the increased scrutiny being brought to bear in the private equity industry is resulting in industry changes. "You see investors asking questions they didn't formally ask before, insisting on certain terms and refusing certain terms," Mr. Bowden said. "Advisers are also modifying their behavior and realizing the tolerance for certain terms is not there."

Private equity firms oversee assets belonging to endowments, pension funds and wealthy individual investors. The firms typically charge these investors 2 percent of assets annually as well as 20 percent of any gains their portfolio companies generate. The investments are usually locked up for at least five years.

Historically, private equity funds have been stellar performers. But in recent years, their performance has dimmed; over the last five years, on average, they have lagged the returns of the broad stock averages.

Amid this decline, some investors have raised concerns about hidden fees levied by private equity funds. They include fees paid by the companies held in the private equity firm's portfolio. The companies end up paying fees to the private equity firm for things like issuing debt or the oversight of portfolio companies, known as monitoring services.

Responding to investor demands, private equity firms now routinely reduce management fees charged to investors by the amount of these expenses, or some portion of them. These arrangements vary from firm to firm and range from offsets of 50 percent of fees to 100 percent.

Investors in funds with these fee arrangements usually rely on the private equity firms to ensure that offsets are properly applied. Considering what transpired at Freeman Spogli, that trust may not always be justified.

The business of private equity has for decades been almost unregulated. But the Dodd-Frank legislation of 2010 required private equity firms with more than $150 million in assets to register as investment advisers with the S.E.C. That registration process began in 2012, and the commission began visiting firms to review their records and practices.

Since the S.E.C. began conducting its first examinations of private equity firms, some of its officials, including Mr. Bowden, have spoken publicly about industry

problems. But specifics about improper practices in the area have been few, and enforcement actions rare.

The Freeman Spogli documents shed light on some of the S.E.C.'s concerns about private equity. Not surprisingly, they revolve around fees that these firms charge.

The S.E.C.'s review of the firm's operations highlighted two critical problems. One deficiency related to the firm's fee-sharing practices. Like many private equity firms, Freeman Spogli had promised to reduce the management fees paid by investors; those reductions are supposed to offset some or all of the transaction fees and other charges levied on its portfolio companies.

But the S.E.C. found that certain affiliates of Freeman Spogli did not fully offset the transaction and consulting fees from companies held in their portfolios, as well as bonuses and reimbursed expenses, as required by two of its funds' limited partnership agreements. The two funds were Freeman Spogli Equity Partners V and VI. The firm's failure to reduce the management fee in both funds was inconsistent with its fiduciary duty, the S.E.C.'s letter said. It asked Freeman Spogli to reimburse the two funds and to "provide evidence of any completed reimbursement."

The S.E.C. findings suggest that investors need to be more vigilant about ensuring that the fee-sharing arrangements they have been promised by private equity firms are actually followed.

The other practice cited by the S.E.C. involved Freeman Spogli's apparent acceptance of fees for providing investment banking-type services even though it was not registered as a broker-dealer. The same two funds were cited in the letter.

"It appears as though Registrant," the letter said, referring to Freeman Spogli, "and its Affiliated Executives may be and have been acting as unregistered broker-dealers based on the receipt of such compensation." The letter added, "Please explain any legal analysis conducted by, or on behalf of, Registrant in determining whether broker-dealer registration is appropriate, including any legal basis or authority on which Registrant has relied."

The commission has questioned other private equity firms about their brokerage activities. One is the Clearlake Capital Group of Santa Monica, Calif. After an S.E.C. examination in 2013, Clearlake also received a deficiency letter about unregistered broker-dealer activities.

In July, Clearlake, responding to questions by one of its pension investors, said it had replied to the deficiency letter, and that the S.E.C. had requested additional information on the matter, according to documents made available to The Times. Email messages to Clearlake asking about the status of the broker-dealer matter were not returned.

Adam Gale, a lawyer at the Mintz Levin firm and co-chairman of its investment funds group, said broker-dealer registration remains an important issue for S.E.C. examiners in their visits to private equity funds.

Securities laws state that "any person engaged in the business of affecting transactions in securities for the account of others" should register as a broker and submit to heightened oversight intended to ensure that its customers are treated fairly.

S.E.C. guidelines echo that: Firms may have to register as broker-dealers if they participate in "important parts of a securities transaction, including solicitation, negotiation or execution of the transaction" and if compensation or participation in the deal depends on the outcome or size of the transaction.

But many private equity firms are not registered as brokers, even though they conduct such transactions. "The registration obligation might kick in if the fund manager or an affiliate is charging success-based fees when the fund is buying or selling a portfolio company," Mr. Gale said.

Most large private equity firms, including Apollo Global Management, the Blackstone Group and KKR, are already registered as broker-dealers. And the registration requirement, Mr. Gale said, may be eliminated if a private equity firm rebates any broker-type charges against its management fee.

Smaller firms typically are not registered as brokers, Mr. Gale said. And one result of S.E.C. scrutiny in this area, he said, is that some smaller firms are deciding against charging any investment banking-type fees. "It's a regulatory headache, and it takes money, time and effort to register as a broker-dealer and to keep up with the ongoing requirements," he said.

With private equity firms under the regulatory microscope, the balance of power may be shifting — at least a bit — away from fund executives and toward investors. The investors in the Freeman Spogli fund, for example, are being given a much more active role in oversight than is typical at private equity funds.

Eileen Appelbaum is senior economist at the Center for Economic and Policy Research in Washington and co-author with Rosemary Batt of "Private Equity at Work: When Wall Street Manages Main Street." Told about the change at the Freeman Spogli fund allowing an independent adviser to monitor its operations, Ms. Appelbaum called it a positive development, especially given the complexity in fee-sharing arrangements.

"It can be very confusing to the limited partners to understand which are the fees that should be shared with them," she said in an interview.

If the practice of hiring an independent monitor took hold at other funds, she added, questionable actions in the industry might change.

"Once you've got lots of limited partners saying 'We're going to hire an independent monitor to look at the books,' " Ms. Appelbaum said, "that's going to change behavior."

A version of this article appears in print on December 28, 2014, on page BU1 of the New York edition with the headline: Entering the Secret Garden of Private Equity.


# EXAMINATION PRIORITIES FOR 2015

## I. Introduction

This document identifies selected 2015 examination priorities of the Office of Compliance Inspections and Examinations ("OCIE," "we" or "our") of the Securities and Exchange Commission ("SEC" or "Commission"). In general, the priorities reflect certain practices and products that OCIE perceives to present potentially heightened risk to investors and/or the integrity of our capital markets.[1]

OCIE serves as the "eyes and ears" of the SEC. We conduct examinations of registered entities to promote compliance, prevent fraud, identify risk, and inform policy.[2] We selected our 2015 examination priorities in consultation with the five Commissioners, senior staff from the SEC's eleven regional offices, the SEC's policy-making and enforcement divisions, the SEC's Investor Advocate, and our fellow regulators.

This year, our priorities focus on issues involving investment advisers, broker-dealers, and transfer agents and are organized around three thematic areas:

1. Examining matters of importance to retail investors and investors saving for retirement, including whether the information, advice, products, and services being offered is consistent with applicable laws, rules, and regulations;

2. Assessing issues related to market-wide risks; and

3. Using our evolving ability to analyze data to identify and examine registrants that may be engaged in illegal activity, such as excessive trading and penny stock pump-and-dump schemes.

This document does not address OCIE's examination priorities for exchanges and SROs, which we are addressing separately.

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[1] This document was prepared by SEC staff, and the views expressed herein are those of OCIE. The Commission has expressed no view on this document's contents. It is not legal advice; it is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.

[2] The registered entities that OCIE examines include investment advisers, investment companies, broker-dealers, exchanges, self-regulatory organizations ("SROs"), clearing agencies, municipal advisors, and transfer agents.

## II. Protecting Retail Investors and Investors Saving for Retirement

Retail investors of all ages face a complex and evolving set of options when determining how to invest their money, including retirement funds. Registrants are developing and offering to retail investors a variety of new products and services that were formerly characterized as alternative or institutional, including private funds, illiquid investments, and structured products intended to generate higher yields in a low-interest rate environment. Additionally, as investors are more dependent than ever on their own investments for retirement,[3] the financial services industry is offering a broad array of information, advice, products, and services to retail investors to help them plan for, and live in, their retirement years. We are planning various examination initiatives to assess risks to retail investors that can arise from these trends.

- **Fee Selection and Reverse Churning**. Financial professionals serving retail investors are increasingly choosing to operate as an investment adviser or as a dually registered investment adviser/broker-dealer, rather than solely as a broker-dealer. Unlike broker-dealers, which typically charge investors a commission or mark-up on purchases and sales of securities, investment advisers employ a variety of fee structures for the services offered to clients, including fees based on assets under management, hourly fees, performance-based fees, wrap fees, and unified fees. Where an adviser offers a variety of fee arrangements, we will focus on recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships.

- **Sales Practices**. We will assess whether registrants are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, especially when they pose greater risks and/or charge higher fees.

- **Suitability**. We will evaluate registered entities' recommendations or determinations to invest retirement assets into complex or structured products and higher yield securities, including whether the due diligence conducted, the disclosures made, and the suitability of the recommendations or determinations are consistent with existing legal requirements.

- **Branch Offices**. We will focus on registered entities' supervision of registered representatives and financial adviser representatives in branch offices, including using data

[3] For decades, employers have shifted from offering defined benefit pensions to defined contribution plans, such as 401(k) accounts, that place funding and investment risk directly on participants. Today, it is estimated that approximately $15.8 trillion is invested in defined contribution plans (including individual retirement accounts and annuity reserves), while approximately $8.3 trillion is invested in defined benefit plans. *See* Nari Rhee, "Retirement Savings Crisis: Is it Worse than We Think" (June 2013), a publication of the NATIONAL INSTITUTE ON RETIREMENT SECURITY, *available at*: http://www.nirsonline.org/index.php?option=com_content&task=view&id=768&Itemid=48; *see also* "Retirement Assets Total $24 Trillion in Second Quarter 2014" (Sept. 2014), a publication of the INVESTMENT COMPANY INSTITUTE, *available at*: http://www.ici.org/research/stats/retirement/ret_14_q2.

analytics to identify branches that may be deviating from compliance practices of the firm's home office.

- **"Alternative" Investment Companies**. Funds holding "alternative" investments, or those offering returns uncorrelated with the stock market, have experienced rapid and significant growth compared to other categories of mutual funds. We will continue to assess funds offering alternative investments and using alternative investment strategies, with a particular focus on: (i) leverage, liquidity, and valuation policies and practices; (ii) factors relevant to the adequacy of the funds' internal controls, including staffing, funding, and empowerment of boards, compliance personnel, and back-offices; and (iii) the manner in which such funds are marketed to investors.

- **Fixed Income Investment Companies**. With interest rates expected to rise at some point in the future, we will review whether mutual funds with significant exposure to interest rate increases have implemented compliance policies and procedures and investment and trading controls sufficient to ensure that their funds' disclosures are not misleading and that their investments and liquidity profiles are consistent with those disclosures.

## III. Assessing Market-Wide Risks

The SEC's mission includes not only investor protection and capital formation, but also maintaining fair, orderly, and efficient markets. With examination authority over a wide variety of registrants, we intend to examine for structural risks and trends that may involve multiple firms or entire industries. In 2015, we will focus on the following initiatives:

- **Large Firm Monitoring**. We will continue to collaborate with our colleagues in the Division of Trading and Markets and the Division of Investment Management to monitor the largest U.S. broker-dealers and asset managers for the purpose of assessing risks at individual firms and maintaining early awareness of developments industry-wide.

- **Clearing Agencies**. We will continue to conduct annual examinations of all clearing agencies designated systemically important, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Areas for review will be determined through a risk-based approach in collaboration with the Division of Trading and Markets and other regulators, as applicable.

- **Cybersecurity**. Last year, we launched an initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and controls. In 2015, we will continue these efforts and will expand them to include transfer agents.

- **Potential Equity Order Routing Conflicts**. We will assess whether firms are prioritizing trading venues based on payments or credits for order flow in conflict with their best execution duties.

## IV. Using Data Analytics to Identify Signals of Potential Illegal Activity

Over the last several years, OCIE has made significant enhancements in data analytics that enable us to efficiently and effectively analyze the data to which we have access. We will use these capabilities to focus on registrants and firms that appear to be potentially engaged in fraudulent and/or other potential illegal activity, including the following examination initiatives:

- **Recidivist Representatives**. We will continue to use our analytic capabilities to identify individuals with a track record of misconduct and examine the firms that employ them.

- **Microcap Fraud**. We will continue to examine the operations of broker-dealers and transfer agents for activities that indicate they may be engaged in, or aiding and abetting, pump-and-dump schemes or market manipulation.

- **Excessive Trading**. We will continue to analyze data obtained from clearing brokers to identify and examine introducing brokers and registered representatives that appear to be engaged in excessive trading.

- **Anti-Money Laundering ("AML")**. We will continue to examine clearing and introducing broker-dealers' AML programs, using our analytic capabilities to focus on firms that have not filed suspicious activity reports ("SARs") or have filed incomplete or late SARs. Additionally, we will conduct examinations of the AML programs of broker-dealers that allow customers to deposit and withdraw cash and/or provide customers direct access to the markets from higher-risk jurisdictions.

## V. Other Initiatives

In addition to examinations related to the themes described above, we expect to allocate examination resources to other priorities, including:

- **Municipal Advisors**. We will continue to conduct examinations of newly registered municipal advisors to assess their compliance with recently adopted SEC and Municipal Securities Rulemaking Board rules. This initiative will include industry outreach and education.

- **Proxy Services**. We will examine select proxy advisory service firms, including how they make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest. We will also examine investment advisers' compliance with their fiduciary duty in voting proxies on behalf of investors.

- **Never-Before-Examined Investment Companies**. We will conduct focused, risk-based examinations of selected registered investment company complexes that we have not yet examined.

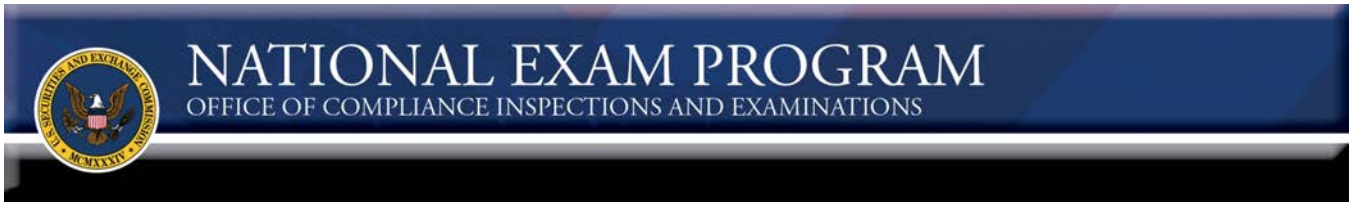
- **Fees and Expenses in Private Equity**. Given the high rate of deficiencies that we have observed among advisers to private equity funds in connection with fees and expenses, we will continue to conduct examinations in this area.

- **Transfer Agents**. Transfer agents serve as important gatekeepers to prevent violations of Section 5 of the Securities Act of 1933 and other fraudulent activity. We intend to allocate more resources to examine transfer agents, particularly those that are involved with microcap securities and private offerings.

## VI. Conclusion

This description of OCIE priorities is not exhaustive. While we expect to allocate significant resources throughout 2015 to the examination issues described herein, our staff will also conduct examinations focused on risks, issues, and policy matters that arise from market developments, new information learned from examinations or other sources, including tips, complaints, and referrals, and coordination with other regulators.

OCIE welcomes comments and suggestions about how we can better fulfill our mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.




# Examination Priorities for 2014[1]

January 9, 2014

## I. Introduction

The National Examination Program ("NEP") is publishing its 2014 examination priorities to communicate with investors and registrants about areas that the staff perceives to have heightened risk and to support the Securities and Exchange Commission ("SEC") mission to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation.

These examination priorities areas were selected collaboratively by senior staff from the NEP's twelve offices, as well as by senior representatives of other SEC divisions and offices, based upon an assessment of a variety of information, including:

- Information reported by registrants in required filings with the SEC,
- Information gathered through examinations conducted by the NEP and other regulators,
- Communications with other U.S. and international regulators and agencies,
- Comments and tips received directly from investors and registrants,
- Data maintained in third party databases,
- Interactions with registrants, industry groups, and service providers outside of examinations, and
- Industry and media publications.

The NEP's examination priorities address issues that span the entire market, as well as issues that relate specifically to particular business models and organizations. The market-wide priorities are addressed first, followed by the priorities for each of the NEP's four program areas: (i) investment advisers and investment companies("IA-IC"), (ii) broker-dealers ("B-D"), (iii) exchanges and self-regulatory organizations ("SROs", and collectively, "market oversight"), and (iv) clearing and transfer agents ("CA" and "TA").

This description of NEP priorities is not exhaustive. While the NEP expects to allocate significant resources throughout 2014 to the examination of the issues described below, the NEP will conduct additional examinations in 2014 focused on risks, issues, and policy matters that are not discussed here. These additional examinations may result from market developments, new information learned from

[1] The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other SEC staff including the Divisions of Trading and Markets, Enforcement, and Investment Management. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

examinations or other sources, and coordination with other regulators. Similarly, the NEP may focus its resources on a subset of the risks and issues identified here.

## II. NEP-Wide Initiatives

The most significant initiatives across the entire NEP include:

**Fraud Detection and Prevention**. Our Nation's capital markets are built on trust. Scams, theft, unfair advantage, and other fraudulent conduct erode that trust and adversely affect investors and the efficient functioning of our markets. [2] As part of its risk-based approach to targeting registrants and business practices, the NEP will continue to utilize and to enhance its quantitative and qualitative tools and techniques to seek to identify market participants engaged in fraudulent or unethical behavior. [3]

**Corporate Governance, Conflicts of Interest, and Enterprise Risk Management**. The NEP will continue to meet with senior management and boards of entities registered with the SEC, including their affiliates where appropriate, to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks. This initiative is designed to: (i) evaluate firms' control environment and "tone at the top," (ii) understand firms' approach to conflict and risk management, and (iii) initiate a dialogue on key risks and regulatory requirements.

**Technology**. The capital markets are experiencing a decades-long revolution in technology, and the increasing complexity, interconnectedness, and speed fostered by technology continues to challenge market participants and regulators. The NEP will continue to examine governance and supervision of information technology systems, operational capability, market access, information security, and preparedness to respond to sudden malfunctions and system outages. [4]

**Dual Registrants**. The convergence among broker-dealer and investment adviser representative activity continues to be a significant risk. For example, representatives of dual registrants, *i.e.*, registrants that are both broker-dealers and investment advisers, and affiliated advisers and broker-dealers may influence whether a customer establishes a brokerage or investment advisory account. This influence

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[2] Examples of fraud cases brought or adjudicated in FY 2013 based on SEC exam referrals include, among many others, In re J.S. Oliver Capital Management (Aug. 30, 2013); SEC v. OM Investment Management LLC (Sept. 27, 2013); SEC v. Advanced Equity Partners, LLC (Sept. 26, 2013), SEC v. Bethancourt (May 7, 2013), In re Johnny Clifton (July 12, 2013); SEC v. Wilson (Nov. 15, 2012); In re Riad (Dec. 19, 2012); and In re Fiduciary Asset management, LLC, Dec. 19, 2012).

[3] The resources that the NEP has expanded in 2013 include its Quantitative Analytics Unit, a team of specialists with post-graduate degrees in fields such as computer science and mathematics that is able to evaluate risks in the algorithms, models, and software of the most sophisticated investment firms, as well as the NEP's Risk Analysis Examination initiative, which examines clearing firms and large broker-dealers by downloading and analyzing all transactions cleared by a firm over a period of several years.

[4] For example, in 2013, the NEP issued a risk alert and a joint public report, with the Commodity Futures Trading Commission and the Financial Industry Regulatory Authority, on business continuity and disaster recovery planning for financial service firms impacted by Hurricane Sandy. *See* Risk Alert on SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year (Aug. 27, 2013), *available at* http://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf, and Joint Review of the Business Continuity and Disaster Recovery Planning of Firms (Aug. 16, 2013), *available at* http://www.sec.gov/about/offices/ocie/jointobservations-bcps08072013.pdf.

may create a risk that customers are placed in an inappropriate account type that increases revenue to the firm and may not provide a corresponding benefit to the customer. The NEP will continue to examine the significant risks to investors of migration and other conflicts this business model presents. The NEP will also continue to examine the impact to investors of the different supervisory structures and legal standards of conduct that govern the provision of brokerage and investment advisory services.

**New Laws and Regulation**. The staff will review general solicitation practices and verification of accredited investor status under newly adopted Rule 506(c) under the Securities Act of 1933 to the extent conducted by a regulated entity; generally will review, monitor, and analyze the use of Rule 506(c); and will evaluate due diligence conducted by broker-dealers and investment advisers for such offerings. As regulatory requirements for crowdfunding offerings and entities become effective, the NEP also expects to examine industry developments and compliance with such new rules.

The staff also will be conducting reviews to assess compliance with the recently adopted rules by municipal advisors. Similarly, in the event that rules are in place regarding security-based swaps dealers and other registered entities created or impacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the staff expects to allocate resources to conduct reviews of those registrants, as well as customer margin and operational practices resulting from centralized clearing for various security-based swap products.

**Retirement Vehicles and Rollovers**. During changes in employment or when entering retirement, investors are left with multiple options as to treatment of their retirement plan assets held at their former employer. Investment advisers and broker-dealers may have incentives to recommend that the assets be placed with an IRA or other alternative offered by a financial services firm. The staff will undertake several initiatives, including:

(a) examining the sales practices of investment advisers targeting retirement-age workers to roll over their employer-sponsored 401(k) plan into higher cost investments, including whether advisers are misrepresenting their credentials or the benefits and features of individual retirement account ("IRA") plans or other alternatives, and

(b) examining broker-dealers and investment advisers for possible improper or misleading marketing and advertising, conflicts, suitability, churning, and the use of potentially misleading professional designations when recommending the movement of assets from a retirement plan to an IRA rollover account in connection with a customer's or client's change of employment.

## III. Program Area-Specific Initiatives

This section discusses risks faced by specific program areas of the NEP. The focus areas are generally divided into core risks, new and emerging risks, and policy topics.

"Core risks" are those risk areas that are common to the business model utilized by a particular category of registrant and that have existed for a sustained period and are likely to continue for the foreseeable future. Certain of these core risks have been selected as focus areas in 2014 because of their significance in recently conducted examinations.

"New and emerging issues and initiatives" are issues and business practices that pose an increased risk due to changes and developments in the industry, including changes in financial conditions, products or investment strategies offered, technology, regulation, business combinations, and business practices.

"Policy topics" are areas in which the SEC has an interest in gaining a better understanding of business practices in a particular area or learning the practical application of previously adopted rules and guidance.

Across all of the program areas, examinations are primarily focused on issues and business practices that are perceived by the staff to present the highest risks to investors and the integrity of the market. Exam scopes will vary from registrant to registrant, depending on the registrant's business activity and the risk associated with such activity. Nevertheless, across each program, certain issues predominate. In addition to the specific risks unique to each registrant, the staff will consider the focus areas described below when scoping and conducting examinations in 2014.

## INVESTMENT ADVISER/INVESTMENT COMPANY PROGRAM

The Investment Adviser/Investment Company ("IA-IC") Program has primary examination authority for approximately 11,000 registered investment advisers and 800 registered investment company complexes. Collectively, these entities manage nearly $55 trillion for investors.

- **Core Risks.**

**Safety of Assets and Custody**. If the markets run on trust, then few things are more important than the safekeeping of clients' assets. Yet, the NEP continues to observe non-compliance with Rule 206(4)-2 under the Advisers Act ("Custody Rule"). In March, 2013, the NEP published a Risk Alert, sharing observations regarding the most common issues of non-compliance.[5] Given the importance of this requirement for a fiduciary, the staff will continue to test compliance with the Custody Rule and confirm the existence of assets through a risk-based asset verification process. Examiners will pay particular attention to those instances where advisers fail to realize they have custody and therefore fail to comply with requirements of the Custody Rule.

**Conflicts of Interest Inherent in Certain Investment Adviser Business Models**.[6] Over time, the staff has observed instances of non-compliance with the federal securities laws very often arise in situations where there are unaddressed conflicts of interest. Registrants engage in activity that puts their own interests ahead of their clients in contravention of their fiduciary duty and existing laws, rules, and

[5] Significant Deficiencies Involving Adviser Custody and Safety of Client Assets (March 4, 2013), *available at* http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf. Cases brought in this area in 2013 arising out of exam referrals include In re GW & Wade, LLC (Oct. 28, 2013), In re Further Lane Asset Management, LLC (Oct. 28, 2013); In re Knelman Asset Management Group, LLC (Oct. 28, 2013); and SEC v. OM Investment Management LLC (Sept. 27, 2013).

[6] Cases brought in 2013 related to conflicts in the adviser business model include In re Goelzer Investment Management (July 31, 2013) (best execution); In re Manarin Investment Counsel, Ltd. (Oct. 2, 2013) (best execution); In re Parallax Investments, LLC (Nov. 26, 2013) (principal transactions); In re Equitas Capital Advisors, LLC (Oct. 23, 2013)(compliance); In re Gisclair (Oct. 23, 2013)(compliance); In re Stastney (Sept.. 18, 2013)(principal transaction); and In re J.S. Oliver Capital Management (Aug. 30, 2013)(cherry-picking, soft dollars).

regulations. Yet, they too often do not perceive or properly mitigate the conflict. The staff will therefore conduct examinations focused on conflicts of interest inherent in the business model, including:

- Compensation arrangements for the adviser, with a particular focus on undisclosed compensation arrangements and their effect on recommendations made to clients,
- The allocation of investment opportunities,
- Controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts,
- Risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies, and
- Higher risk products or strategies targeted to retail (and especially retired or elderly) investors.

**Marketing/Performance**.[7] The staff will review the accuracy and completeness of advisers' claims about their investment objectives and performance. For example, the staff will review and test hypothetical and back-tested performance, the use and disclosure of composite performance figures, performance record keeping, and compliance oversight of marketing. The staff also expects to review marketing efforts arising out of newly effective rules adopted under the Jumpstart Our Business Startups ("JOBS") Act.

- **New and Emerging Issues and Initiatives**.

**Never-Before Examined Advisers**. This initiative will address advisers that have never been examined and are not part of the Presence Exam initiative (referenced below). The staff will utilize a number of strategies to conduct focused, risk-based examinations of the adviser population that has been registered for more than three years but has not yet been examined by the NEP.

**Wrap Fee Programs**. The staff will assess whether advisers are fulfilling their fiduciary and contractual obligations to clients and will review the processes in place for monitoring wrap fee programs recommended to advisory clients, related conflicts of interest, best execution, trading away from the sponsor, and disclosures.

**Quantitative Trading Models**. The staff will examine investment advisers with substantial reliance on quantitative portfolio management and trading strategies and assess, among other things, whether these firms have adopted and implemented compliance policies and procedures tailored to the performance and maintenance of their proprietary models, including such procedures as (i) evaluating if any models are used to manipulate the markets, (ii) reasonably review or test the models and their output over time, (iii) maintaining proper documentation within required books and records, and (iv) maintaining a current inventory of all firm-wide proprietary models.

**Presence Exams**. The staff will continue the 2012 initiative to examine a significant percentage of the advisers registered since the effective date of Section 402 of the Dodd-Frank Act. The five key focus areas of these examinations are marketing, portfolio management, conflicts of interest, safety of client assets, and valuation. The vast majority of these new registrants are advisers to hedge funds and private

[7] Cases in 2013 concerning marketing and performance that arose out of SEC exam referrals include In re Modern Portfolio Management, Inc. (Oct. 23, 2013).

equity funds that were not registered or regulated by the SEC prior to the Dodd-Frank Act, and have never been examined by the SEC. The staff will also continue to prioritize examinations of private fund advisers where the staff's analytics indicate higher risks to investors, or where there are indicia of fraud, broker-dealer status concerns, or other serious wrongdoing.[8]

**Payments for Distribution in Guise**. The staff will continue its review of the variety of payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments, and boards' oversight of the same. The staff will assess whether such payments are, in fact, payments for distribution and preferential treatment.

**Fixed Income Investment Companies**. The staff will monitor the risks associated with a changing interest rate environment and the impact this may have on bond funds and related disclosures of risks to investors.

- **Policy Topics.**

**Money Market Funds**.[9] NEP staff will continue targeting some examinations at money market funds, focusing particularly on how they have managed any potential stress events and working with Division of Investment Management staff to examine particular money market funds that exhibit outlier behavior in some respect.

**"Alternative" Investment Companies**. The staff will continue its assessment of funds offering "alternative" investment strategies, with a particular focus on: (i) leverage, liquidity and valuation policies and practices; (ii) the staffing, funding, and empowerment of boards, compliance personnel, and back-offices; and (iii) the manner in which such funds are marketed to investors. The staff will additionally review the representations and recommendations made regarding the suitability of such investments.

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[8] As of September 30, 2013, over 200 presence exams had been completed and the Presence Exam initiative was on pace to meet its goal of touching 25 per cent of advisers newly registered with the SEC under the Dodd-Frank Act within two years. Examination teams from every regional office have participated in the Presence Exam initiative. Exam teams have identified multiple issues in each of the five focus areas mentioned above. Presence examinations have contributed to several developments in 2013, including

(a) guidance from the Division of Investment Management that resulted from information about the application of the Advisers Act custody rule to non-transferable stock certificates held by audited pooled investment vehicles. The guidance states that the Staff would not object if an adviser to a pooled investment vehicle does not maintain non-transferable stock certificates or "certificated" LLC interests obtained in a private placement with its custodian if certain conditions are met. *See* http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf; and

(b) a speech by an official in the Division of Trading and Markets cautioning private fund advisers on broker-dealer registration issues identified in several examinations. "A Few Observations in the Private Fund Space," Remarks by David W. Blass (April 5, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171515178.

[9] Cases brought in 2013 involving money-market fund operations include Ambassador Capital Management, LLC (Nov. 26, 2013).

**Securities Lending Arrangements**. The staff will examine securities lending arrangements to determine whether they comply with exemptive orders and evaluate consistency with relevant no-action letters.

## BROKER-DEALER EXAM PROGRAM

The Broker-Dealer ("B-D") Program manages the SEC's examination program for nearly 4,500 registered broker-dealers with approximately 113 million customer accounts, over 160,000 branch offices, and over 630,000 registered representatives. The B-D Program also coordinates closely with the Financial Industry Regulatory Authority ("FINRA"), other SRO's and state regulators to share information from examinations, compare priorities, and maximize examination coverage.

- **Core Risks.**

**Sales Practices/Fraud**.[10] The B-D Program will conduct examinations to detect and to prevent fraud and other violations in connection with sales practices to retail investors, including:

- Affinity fraud targeting seniors or other groups,
- Micro-cap fraud and pump and dump schemes,
- Unsuitable recommendations of higher yield and complex products (e.g., leveraged ETFs and structured products), as well as the adequacy of due diligence, and
- Unregistered entities engaged in the sale or promotion of unregistered offerings or other unusual capital raising activities.

**Supervision**.[11] The staff will focus on broker-dealers' supervision of: (i) independent contractors and financial advisors in "remote" locations and large branch offices, (ii) registered representatives with significant disciplinary histories, and (iii) private securities transactions. All three factors present challenges to the ability of the broker-dealer to supervise with a view to preventing securities law violations.

**Trading**.[12] The staff will focus on market access controls related to, among other things, erroneous orders; the use of technology with a focus on algorithmic and high frequency trading; information leakage and cyber security; market manipulation involving practices such as marking the close, parking, fraudulent stimulation of demand (spoofing), and excessive markups and markdowns. The staff will

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[10] SEC cases brought or adjudicated in 2013 included In re Clifton (July 12, 2013) (oil and gas leases) and In re Advanced Equity (Sept. 26, 2013)(sale of unregistered stock to senior citizens). In addition, a case brought in 2012 involving a broker-dealer registered representative who misappropriated funds from a 94-year old retiree, among other charges, resulted in a recent four year prison sentence in a parallel criminal matter. *See* SEC v. Rothman (Sept. 24, 2012), "Judge Sentences Bucks County Investment Advisor to Four years for Embezzlement Scheme," *available at* http://www.justice.gov/usao/pae/News/2013/November/rothman_release.htm (Nov. 14, 2013). *See also* Investor Bulletin: Affinity Fraud, by the SEC Office of Investor Advocacy and Education *available at* http://investor.gov/news-alerts/affinity-fraud.

[11] SEC cases brought in 2013 involving allegations of failure to supervise independent contractors, financial adviser or registered representatives include In re Saviano (Sept. 6, 2013) and In re Hernandez, (Sept. 24, 2013).

[12] SEC cases regarding significant trading issues brought in 2013 included In re Knight Capital Americas LLC (Oct. 16, 2013) and SEC v. Bethancourt (May 7, 2013).

also examine for abuses of the bona-fide market making exception to Regulation SHO, and will examine relationships between broker-dealers and Alternative Trading Systems ("ATSs").

**Internal Controls**. The staff will assess the standing, authority, and effectiveness of key control functions; including liquidity, credit, and market risk management practices; internal audit; valuation practices; and compliance.

**Financial Responsibility**. In addition, the staff will review for compliance with the customer protection and the net capital rules[13] with a focus on assets collateralizing large concentrated customer debit balances and the liquidity of firm inventory. For those firms computing net capital pursuant to Appendices E and F of the net capital rule[14] and its associated modeling requirements, the staff will review data integrity and test the approval process for any changes in such models.

**AML**. The staff will review clearing and introducing firms to assess anti-money laundering ("AML") programs. The staff will also conduct examinations of the AML programs of proprietary trading firms that allow customers direct access to the markets from higher risk jurisdictions.

- **New and Emerging Issues and Initiatives.**

**Exchange Act Rule 15c3-5 ("Market Access Rule")**. Among other issues, the staff will examine whether firms are appropriately applying the Market Access Rule (effective July 14, 2011) to their proprietary trading, as well as the adequacy of books and records maintained by broker-dealers that provide market access through master/subaccount arrangements.[15]

**Suitability of Variable Annuity Buybacks**. Some current holders of variable products have guaranteed income benefits and death benefits that have substantially increased in value due to current market conditions. Recent news articles have suggested that insurance companies are offering to repurchase the products. If the customer accepts the offer, the customer may need to purchase a new variable product with less favorable terms. The staff will examine whether registered representatives are recommending that customers accept the buyback terms and, if so, whether such recommendations are suitable and what types of disclosure are made to the customer.

**Fixed Income Market.** The staff will focus on a number of issues, including the structure of the market and its effect on the quality of executions and, in particular, the use of filters by market participants to control what is displayed by fixed income ATSs. The staff will evaluate factors that may impact the quality of execution in the fixed income market, including market structure and the use of ATS. For example, ATS interfaces may impact the range of quotations displayed to market participants.

## MARKET OVERSIGHT EXAM PROGRAM

[13] Rules 15c3-3 and 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act").

[14] Rule 15c3-3e under the Exchange Act.

[15] *See* National Exam Risk Alert, Master/Sub-Accounts (Sept. 29, 2011), *available at* http://www.sec.gov/about/offices/ocie/riskalert-mastersubaccounts.pdf.

OCIE's Office of Market Oversight is responsible for examining certain SROs and exchanges to evaluate their compliance with applicable federal securities laws and rules and the SRO's own rules. The SROs subject to Market Oversight's review include the national securities exchanges (both equity and options market centers), FINRA, and the Municipal Securities Rulemaking Board. Market Oversight also oversees the Public Company Accounting Oversight Board and the Securities Investor Protection Corporation. The staff anticipates that its risk-based exam focus in 2014 will include the following priorities:

**Oversight of FINRA**. The staff will continue to review the examination areas outlined in Section 964 of the Dodd-Frank Act and other program areas.

**Exchange Examinations**. The staff will conduct risk targeted exams focused on areas of perceived control weakness at the exchanges. In addition, the staff will continue its review of order types by focusing on the options exchanges. The staff will also continue to follow up on business continuity planning at the exchanges.

**New Registrants**. The staff, in coordination with the Division of Trading and Markets, will conduct pre-launch reviews of new exchange applicants to determine whether each applicant is organized and has the capacity to carry out its responsibilities as an SRO by enforcing its members' compliance with the federal securities laws and rules and the exchange's own rules. The staff will also review exchanges undergoing ownership changes to assess their continued compliance with applicable laws and rules. In addition, the staff expects to allocate resources to begin examining security-based swap execution facilities if the SEC adopts final rules requiring their registration.

**Section 31 Fee Examinations**. The staff will conduct its annual review of controls and policies and procedures to ensure accurate reporting and payment of Section 31 fees.

## CLEARANCE AND SETTLEMENT EXAM PROGRAM

The Clearance and Settlement Program currently consists of two registrant types and associated exam programs: Clearing Agencies and Transfer Agents.[16]

### A. Clearing Agencies

The Clearance and Settlement Program currently has responsibility for annually examining four clearing agencies designated as systemically important by the Financial Stability Oversight Council under the Dodd-Frank Act. It currently also has oversight responsibility for two other clearing agencies, and has assisted in examinations of two clearing agencies for which the CFTC is the primary supervisory agency. For 2014, the staff anticipates that it will focus on the following areas:

[16] Security-based Swap Data Repositories ("SDRs") will be incorporated into the Clearance and Settlement Program once these entities are required to register with the SEC pursuant to regulations enacted under the Dodd-Frank Act. In the event that further rulemaking occurs during 2014 affecting SDRs, NEP staff will review draft rules to provide the examination perspective.

**Annual Exams Mandated by the Dodd-Frank Act**. The Dodd-Frank Act requires all systemically designated clearing agencies to be examined annually by their primary supervisory agency. The SEC is the primary supervisory agency for:

- Depository Trust Company ("DTC"),
- National Securities Clearing Corporation ("NSCC"),
- Fixed Income Clearing Corporation ("FICC"), and
- Options Clearing Corporation ("OCC").

Areas for review will be determined through a risk-based approach, incorporating new rules and standards, and in collaboration with the Division of Trading and Markets and other regulators, as applicable.

**Other Examinations**. The staff will continue to utilize a risk based approach to examine clearing agencies. With the adoption of Exchange Act Rule 17Ad-22, the staff will focus on the clearing agencies' compliance with this Rule.

**New Registrants**. The staff, in coordination with the Division of Trading and Markets, will conduct pre-launch reviews of new clearing agency applicants to determine whether each applicant is organized and has the capacity to carry out its responsibilities as an SRO by complying with the federal securities laws and rules as well as their own rules and by enforcing compliance by its members of the clearing agency's own rules. In addition, the staff expects to allocate resources to begin examining security-based swap data repositories if the SEC adopts final rules requiring their registration.

### B. Transfer Agents[17]

The Transfer Agent Program has examination authority for approximately 450 transfer agents consisting of both SEC-registered (approximately 75% of the transfer agent population) and bank-registered transfer agents. The full transfer agent population maintains over 276 million shareholder accounts for approximately 1.5 million issuers (including equity, debt, and mutual fund securities) as reported for the end of 2012. In addition to core transfer agent services (defined below), certain transfer agents may provide paying agent services, which reported at the end of 2012 distributing over $2.15 trillion in shareholder dividends and interest payments.

**Transfer Agent Core Activities**. Most, if not all, transfer agents engage in three core activities: the timely turnaround of items and transfers (Exchange Act Rule 17Ad-2); accurate recordkeeping and associated retention (Exchange Act Rules 17Ad-6 and 17Ad-7); and safeguarding funds and securities (Exchange Act Rule 17Ad-12). The staff will examine compliance and controls in these critical core activities.

**Other Areas of Focus**:

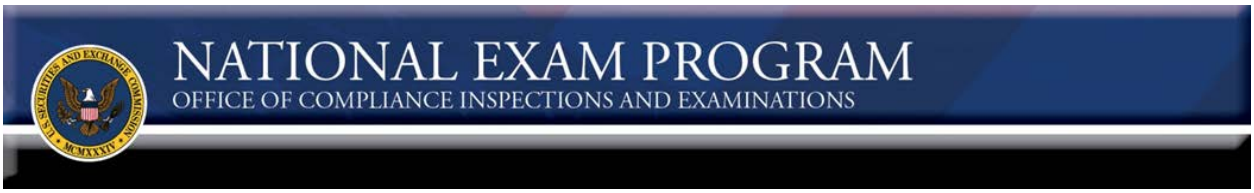
- Transfer agents that service microcap securities and private offerings,
- Policies and procedures adopted by transfer agents for handling and transferring certificates damaged by Hurricane Sandy and for Letters of Indemnity received from the DTC, and

[17] Cases filed or adjudicated in 2013 involving transfer agent issues include In re Securities Transfer, Inc. (July 23, 2013) and In re Korem (July 26, 2013).

- Transfer agents that provide "third party" administration (services similar to transfer agent recordkeeping functions but performed for parties other than the issuer of a Section 12 security, such as retirement plans). Among other things, the staff will evaluate whether entities that provide these services are appropriately registered or exempt from broker-dealer registration.

**Direct Registration System**. Transfer agents that are registered Fast Automated Transfer Program agents with DTC, may offer security holders an option to maintain their ownership on the books of the issuer. The Direct Registration System provides registered owners with the option of holding their assets on the books and records of the transfer agent in book-entry form. As this ownership method becomes more popular (as opposed to street-name or certificate ownership), the staff will review transfer agents' policies and procedures around order taking, recordkeeping, and clearing relationships.

**Business Continuity and Disaster Recovery Plans**. The staff will review the adequacy of transfer agents' business continuity and disaster recovery plans based on the size and scope of their business models.




# EXAMINATION PRIORITIES FOR 2015

## I. Introduction

This document identifies selected 2015 examination priorities of the Office of Compliance Inspections and Examinations ("OCIE," "we" or "our") of the Securities and Exchange Commission ("SEC" or "Commission"). In general, the priorities reflect certain practices and products that OCIE perceives to present potentially heightened risk to investors and/or the integrity of our capital markets.[1]

OCIE serves as the "eyes and ears" of the SEC. We conduct examinations of registered entities to promote compliance, prevent fraud, identify risk, and inform policy.[2] We selected our 2015 examination priorities in consultation with the five Commissioners, senior staff from the SEC's eleven regional offices, the SEC's policy-making and enforcement divisions, the SEC's Investor Advocate, and our fellow regulators.

This year, our priorities focus on issues involving investment advisers, broker-dealers, and transfer agents and are organized around three thematic areas:

1. Examining matters of importance to retail investors and investors saving for retirement, including whether the information, advice, products, and services being offered is consistent with applicable laws, rules, and regulations;

2. Assessing issues related to market-wide risks; and

3. Using our evolving ability to analyze data to identify and examine registrants that may be engaged in illegal activity, such as excessive trading and penny stock pump-and-dump schemes.

This document does not address OCIE's examination priorities for exchanges and SROs, which we are addressing separately.

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[1] This document was prepared by SEC staff, and the views expressed herein are those of OCIE. The Commission has expressed no view on this document's contents. It is not legal advice; it is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.

[2] The registered entities that OCIE examines include investment advisers, investment companies, broker-dealers, exchanges, self-regulatory organizations ("SROs"), clearing agencies, municipal advisors, and transfer agents.

## II. Protecting Retail Investors and Investors Saving for Retirement

Retail investors of all ages face a complex and evolving set of options when determining how to invest their money, including retirement funds. Registrants are developing and offering to retail investors a variety of new products and services that were formerly characterized as alternative or institutional, including private funds, illiquid investments, and structured products intended to generate higher yields in a low-interest rate environment. Additionally, as investors are more dependent than ever on their own investments for retirement,[3] the financial services industry is offering a broad array of information, advice, products, and services to retail investors to help them plan for, and live in, their retirement years. We are planning various examination initiatives to assess risks to retail investors that can arise from these trends.

- **Fee Selection and Reverse Churning**. Financial professionals serving retail investors are increasingly choosing to operate as an investment adviser or as a dually registered investment adviser/broker-dealer, rather than solely as a broker-dealer. Unlike broker-dealers, which typically charge investors a commission or mark-up on purchases and sales of securities, investment advisers employ a variety of fee structures for the services offered to clients, including fees based on assets under management, hourly fees, performance-based fees, wrap fees, and unified fees. Where an adviser offers a variety of fee arrangements, we will focus on recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships.

- **Sales Practices**. We will assess whether registrants are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, especially when they pose greater risks and/or charge higher fees.

- **Suitability**. We will evaluate registered entities' recommendations or determinations to invest retirement assets into complex or structured products and higher yield securities, including whether the due diligence conducted, the disclosures made, and the suitability of the recommendations or determinations are consistent with existing legal requirements.

- **Branch Offices**. We will focus on registered entities' supervision of registered representatives and financial adviser representatives in branch offices, including using data

[3] For decades, employers have shifted from offering defined benefit pensions to defined contribution plans, such as 401(k) accounts, that place funding and investment risk directly on participants. Today, it is estimated that approximately $15.8 trillion is invested in defined contribution plans (including individual retirement accounts and annuity reserves), while approximately $8.3 trillion is invested in defined benefit plans. *See* Nari Rhee, "Retirement Savings Crisis: Is it Worse than We Think" (June 2013), a publication of the NATIONAL INSTITUTE ON RETIREMENT SECURITY, *available at*: http://www.nirsonline.org/index.php?option=com_content&task=view&id=768&Itemid=48; *see also* "Retirement Assets Total $24 Trillion in Second Quarter 2014" (Sept. 2014), a publication of the INVESTMENT COMPANY INSTITUTE, *available at*: http://www.ici.org/research/stats/retirement/ret_14_q2.

analytics to identify branches that may be deviating from compliance practices of the firm's home office.

- **"Alternative" Investment Companies**. Funds holding "alternative" investments, or those offering returns uncorrelated with the stock market, have experienced rapid and significant growth compared to other categories of mutual funds. We will continue to assess funds offering alternative investments and using alternative investment strategies, with a particular focus on: (i) leverage, liquidity, and valuation policies and practices; (ii) factors relevant to the adequacy of the funds' internal controls, including staffing, funding, and empowerment of boards, compliance personnel, and back-offices; and (iii) the manner in which such funds are marketed to investors.

- **Fixed Income Investment Companies**. With interest rates expected to rise at some point in the future, we will review whether mutual funds with significant exposure to interest rate increases have implemented compliance policies and procedures and investment and trading controls sufficient to ensure that their funds' disclosures are not misleading and that their investments and liquidity profiles are consistent with those disclosures.

## III. Assessing Market-Wide Risks

The SEC's mission includes not only investor protection and capital formation, but also maintaining fair, orderly, and efficient markets. With examination authority over a wide variety of registrants, we intend to examine for structural risks and trends that may involve multiple firms or entire industries. In 2015, we will focus on the following initiatives:

- **Large Firm Monitoring**. We will continue to collaborate with our colleagues in the Division of Trading and Markets and the Division of Investment Management to monitor the largest U.S. broker-dealers and asset managers for the purpose of assessing risks at individual firms and maintaining early awareness of developments industry-wide.

- **Clearing Agencies**. We will continue to conduct annual examinations of all clearing agencies designated systemically important, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Areas for review will be determined through a risk-based approach in collaboration with the Division of Trading and Markets and other regulators, as applicable.

- **Cybersecurity**. Last year, we launched an initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and controls. In 2015, we will continue these efforts and will expand them to include transfer agents.

- **Potential Equity Order Routing Conflicts**. We will assess whether firms are prioritizing trading venues based on payments or credits for order flow in conflict with their best execution duties.

## IV. Using Data Analytics to Identify Signals of Potential Illegal Activity

Over the last several years, OCIE has made significant enhancements in data analytics that enable us to efficiently and effectively analyze the data to which we have access. We will use these capabilities to focus on registrants and firms that appear to be potentially engaged in fraudulent and/or other potential illegal activity, including the following examination initiatives:

- **Recidivist Representatives**. We will continue to use our analytic capabilities to identify individuals with a track record of misconduct and examine the firms that employ them.

- **Microcap Fraud**. We will continue to examine the operations of broker-dealers and transfer agents for activities that indicate they may be engaged in, or aiding and abetting, pump-and-dump schemes or market manipulation.

- **Excessive Trading**. We will continue to analyze data obtained from clearing brokers to identify and examine introducing brokers and registered representatives that appear to be engaged in excessive trading.

- **Anti-Money Laundering ("AML")**. We will continue to examine clearing and introducing broker-dealers' AML programs, using our analytic capabilities to focus on firms that have not filed suspicious activity reports ("SARs") or have filed incomplete or late SARs. Additionally, we will conduct examinations of the AML programs of broker-dealers that allow customers to deposit and withdraw cash and/or provide customers direct access to the markets from higher-risk jurisdictions.

## V. Other Initiatives

In addition to examinations related to the themes described above, we expect to allocate examination resources to other priorities, including:

- **Municipal Advisors**. We will continue to conduct examinations of newly registered municipal advisors to assess their compliance with recently adopted SEC and Municipal Securities Rulemaking Board rules. This initiative will include industry outreach and education.

- **Proxy Services**. We will examine select proxy advisory service firms, including how they make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest. We will also examine investment advisers' compliance with their fiduciary duty in voting proxies on behalf of investors.

- **Never-Before-Examined Investment Companies**. We will conduct focused, risk-based examinations of selected registered investment company complexes that we have not yet examined.

- **Fees and Expenses in Private Equity**. Given the high rate of deficiencies that we have observed among advisers to private equity funds in connection with fees and expenses, we will continue to conduct examinations in this area.

- **Transfer Agents**. Transfer agents serve as important gatekeepers to prevent violations of Section 5 of the Securities Act of 1933 and other fraudulent activity. We intend to allocate more resources to examine transfer agents, particularly those that are involved with microcap securities and private offerings.

## VI. Conclusion

This description of OCIE priorities is not exhaustive. While we expect to allocate significant resources throughout 2015 to the examination issues described herein, our staff will also conduct examinations focused on risks, issues, and policy matters that arise from market developments, new information learned from examinations or other sources, including tips, complaints, and referrals, and coordination with other regulators.

OCIE welcomes comments and suggestions about how we can better fulfill our mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

NATIONAL EXAM PROGRAM
RISK ALERT

*This Risk Alert summarizes OCIE staff observations on the due diligence practices of certain investment advisers that manage and/or recommend alternative investments to their clients.*

*Practices employed by some advisers that may provide greater transparency and that independently support the information provided by underlying managers include: (i) the use of separate accounts to gain full transparency and control; (ii) the use of transparency reports issued by independent fund administrators and risk aggregators; (iii) the verification of relationships with critical service providers; (iv) the confirmation of existence of assets; (v) routinely conducting onsite reviews; (vi) the increased emphasis on operational due diligence; and (vii) having independent providers conduct comprehensive background checks.*

*By the Office of Compliance Inspections and Examinations*[1]

**Volume IV, Issue 1** **January 28, 2014**

# INVESTMENT ADVISER DUE DILIGENCE PROCESSES FOR SELECTING ALTERNATIVE INVESTMENTS AND THEIR RESPECTIVE MANAGERS

For at least the past six years, staff in the Office of Compliance Inspections and Examinations (the "staff" and "OCIE" respectively) have observed and outside studies have indicated that investment advisers, including pension consultants, are increasingly recommending alternative investments to their clients.[2] Investment advisers are fiduciaries and thus must act in their clients' best interests.[3] An adviser that exercises discretion to purchase alternative investments on behalf of its clients, or that relies on a manager[4] to perform due diligence of alternative investments, must determine whether such investments: (i) meet the clients' investment objectives; and (ii) are consistent with the investment principles and strategies that were disclosed by the manager to the adviser (as set forth in various documents, such as advisory disclosure documents, private offering memoranda, prospectuses, or other offering materials provided

1 The views expressed herein are those of the staff of OCIE, in coordination with other Securities and Exchange Commission ("SEC") staff, including in the Division of Enforcement's Asset Management Unit and the Division of Investment Management. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

2 Alternative investments include private funds such as hedge funds, private equity, venture capital, real estate, and funds of private funds. According to a June 2012 research report by McKinsey & Company, the Assets Under Management for global alternative investments have grown to a record $6.5 trillion, having grown at a five-year rate of more than seven times that of traditional asset classes. The study defines alternative investments in a similar way as noted above. McKinsey & Company, *The Mainstreaming of Alternative Investments* (June 2012).

3 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), *available at* http://www.sec.gov/about/offices/ocie/iainfo/capitalgains1963.pdf.

4 As used in this Alert, the term "adviser" refers to registered investment advisers that the staff examined, and "manager" refers to the managers of the alternative investments that the adviser recommends to its clients.

by the manager).[5] The due diligence process can be more challenging for alternative investments due to the characteristics of private offerings, including the complexity of certain alternative investment strategies.

The staff examined[6] the due diligence and related investment advisory processes of certain advisers to pension plans and funds of private funds in order to evaluate how these advisers: (i) performed their due diligence; (ii) identified, disclosed, and mitigated conflicts of interest (*e.g.*, benefits to the adviser or its employees for allocations made to private funds); and (iii) utilized experienced investment teams when evaluating complex investment strategies and fund structures.[7]

## I. Staff Observations – Industry Practices

### A. Industry Trends

The staff observed several widespread trends regarding advisers' due diligence processes.[8] Several of these observations are noted below.

#### i. Advisers Are Seeking More and Broader Information and Data Directly from Managers of Alternative Investments

- *Position-Level Transparency.* The staff noticed increased requests from advisers, as compared to the staff's experience in prior time periods, for position-level transparency of the alternative investments. This observation was confirmed through discussions with the advisers. The staff further noted that while some managers were willing to provide additional transparency, others were reluctant to share detailed information about their alternative investments. In particular, these managers were sensitive to sharing position-level

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5 The staff observed that, in general, registered advisers performed distinct due diligence reviews of both the alternative investment fund under consideration and its manager.

6 The staff conducted more than ten examinations of SEC-registered investment advisers, pursuant to Section 204 of the Investment Advisers Act of 1940 ("Advisers Act"). The staff's examinations focused on advisers that invested in or recommended private fund and fund of private fund investments (*e.g.*, hedge funds and private equity funds). As of the time of the examinations, these advisers managed approximately $2 trillion in investor assets. The staff did not examine commodity pools and registered investment companies that pursue alternative strategies.

7 Staff from the Division of Enforcement brought a settled enforcement action, which alleged that certain fund advisers did not perform two of the five elements of the due diligence evaluation that they had represented to their clients they would undertake. In addition, the staff alleged that the advisers failed to adequately respond to information that they received, which suggested that the identity of the fund's outside auditor was in doubt and that there existed a potential conflict of interest between one of the fund's principals and its purported outside auditor. *In the Matter of Hennessee Group LLC and Charles J. Grandante*, Investment Advisers Act Release No. 2871 (April 22, 2009), *available at* http://www.sec.gov/litigation/admin/2009/ia-2871.pdf.

8 The staff does not take a position regarding the compliance effectiveness or ineffectiveness of the industry practices discussed in this section of this Risk Alert. The adequacy of the industry practices discussed in this Risk Alert can be determined only with reference to the profile of each specific firm and other facts and circumstances.

information, which they felt may compromise their ability to execute their strategies. Position-level transparency was typically used by the advisers' risk assessment teams to: (i) fine-tune analyses of market sector exposures; (ii) identify position concentrations across the client's entire portfolio; and (iii) identify individual positions that may present risks that were anomalous or inconsistent with managers' stated investment strategies. The position-level transparency ultimately provided to the advisers by the alternative investment managers tended to be the result of a process of negotiation between advisers and managers and depended on several factors, including the relative influence of the investors and whether the manager viewed position-level transparency as sensitive proprietary information.

- *Separate Account Management.* Some advisers recommended that their clients' assets be managed within a separate account to: (i) provide full transparency and greater control over how the assets are invested (the manager's authority over the assets is limited to trading authority); (ii) allow for better monitoring of the investment portfolio's liquidity and valuation; and (iii) reduce the ability of a manager to misappropriate client assets or charge unauthorized fees or expenses. The staff understands that many managers continue to prefer a pooled investment structure, based on their beliefs that such structures minimize expenses, increase operational efficiency, and reduce the risk of inequitable treatment of investors. As with the degree of position-level transparency, the staff noted that the resulting investment structure was increasingly determined through a negotiation between managers and advisers. The staff also observed that the key factors in such negotiations were the susceptibility of assets to misappropriation, transparency into the alternative investment funds' portfolio holdings, expenses incurred, and efficiency of operations.

### ii. Advisers Are Utilizing Third Parties to Supplement Analyses and Validate Information Regarding Alternative Investments

- *Portfolio Information Aggregators (Risk Aggregators).* The staff noticed, as compared to previous staff observations and as confirmed by the advisers examined, that advisers increased their use of portfolio information aggregators. Aggregators are generally third-party service providers that receive detailed portfolio-level information from private alternative investment funds, aggregate that information and transmit the aggregated information to advisers conducting due diligence. Advisers used the aggregated information to make broad assessments of the risks of the particular alternative investments. The aggregated information provided to advisers by aggregators was intended to control the disclosure of sensitive information regarding the alternative investment fund's specific positions. The staff observed that in some cases the use of aggregators was a compromise between the adviser and the manager to resolve differing preferences for position-level transparency between investors and managers.

- *Third-Party Service Provider Verification of Relationships and Assets.* The staff observed that many advisers were independently verifying alternative investment relationships and assets with key third-party service providers, such as administrators, custodians, and auditors. As gatekeepers, these key service providers play a very important role for private alternative investment funds. As such, the staff observed that due diligence professionals appeared to have placed a greater emphasis on verifying the existence of these relationships, and, in some

cases, also were verifying that the assets were in fact serviced by the administrator and held at the custodians identified. In addition, the staff observed that if the adviser was not familiar with a service provider, some advisers would conduct a certain amount of due diligence on the service provider in an effort to ensure that the service provider can provide an adequate level of service to the alternative investment.

- *Independent Administration*. The staff observed that some advisers would not make a new investment or recommendation in a private alternative investment fund if the private fund did not have an independent third-party administrator. While not required to do so by law, the staff observed that many advisers invested exclusively with managers that engaged an independent administrator to conduct comprehensive fund administration services such as performing net asset value calculations, fund accounting, trade reconciliation, and processing and recording shareholder activity. The staff understands that the genesis for such an adviser-mandated requirement is the belief that independent administrative services may mitigate certain investment and operational risks, such as the misappropriation of investor assets, and ensures segregation of duties.

- *Third-Party Administrator-Issued Transparency Reports*. The staff observed that many advisers have started receiving "transparency reports" directly from, and independently produced by, third-party administrators for the benefit of alternative investment investors. These reports are designed to provide investors with periodic reporting and an increased level of transparency with respect to the alternative investments' positions. An administrator's report typically includes information about an alternative investment's: (i) net asset value and the percentage of its investments that are confirmed by the administrator with independent custodians; (ii) custodians holding its investments; (iii) percentage of investments that are priced by a third-party administrator; and (iv) assets and liabilities which are measured at "fair value" and are categorized using the fair value hierarchy (Level 1, 2, or 3) established under FASB ASC 820, Fair Value Measurements.

- *Independent Background Checks*. The staff observed that most advisers employed the services of third-party firms to conduct comprehensive background checks on the managers and their key personnel. The staff also observed that many advisers implemented the use of background checks to supplement their own due diligence processes. The background check services were typically outsourced to third-party firms specializing in such services and often included investigating employment history, legal and regulatory matters, news sources, and independent reference checks.

- *Regulatory History Review*. The staff observed that some advisers utilized FINRA BrokerCheck, a publicly available tool,[9] to research the backgrounds of current and former FINRA registered brokerage firms and individual broker-dealer registered representatives. Along with BrokerCheck, the staff also observed that some advisers reviewed regulatory filings, such as Form ADV — available on the Commission's Investment Adviser Public Disclosure website[10] — and requested that the manager provide the adviser with any

[9] *Available at* http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

[10] *Available at* http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx

examination-related letters from the SEC. The staff understands that advisers typically used this information to identify important regulatory issues and potential control weaknesses at the managers.

### iii. Advisers Are Performing Additional Quantitative Analyses and Risk Measures on the Alternative Investments and Their Managers

- *Detection of Manipulation of Performance Returns.* As compared to the staff's observations in earlier time periods, the staff observed that advisers were increasing the use of quantitative analysis in an attempt to detect aberrations in investment returns. This measure is intended to identify managers that have falsified or otherwise manipulated their returns. Advisers confirmed their increased use of these measures, which typically included: (i) bias ratio; (ii) serial correlation; and (iii) "skewness" of the return distribution. These measures also were analyzed in conjunction with factor analysis of the returns in order to detect suspect returns that may be an indication of manipulation.

- *Supplementation of Investment-Level Decision-Making.* The staff observed that advisers have increased their use of quantitative risk measures to supplement investment-level decision-making processes. The risk measurements supplemented the investment due diligence process (*e.g.*, through measures such as factor analysis to provide an indication as to how closely a manager was implementing the stated strategic approach). The staff also observed that some advisers' risk teams used sophisticated quantitative measures to identify potential problems before those problems would manifest in performance returns or adverse reports from the manager.

### iv. Advisers Are Enhancing and Expanding Their Due Diligence Processes and Focus Areas

- *Operational Due Diligence Focus.* The staff observed that although many advisers have always had a focus on operational due diligence, some advisers have increased their efforts in this critical area and other advisers established operational due diligence groups.[11] For example, the staff found that many advisers had experienced, dedicated operational teams with the ability to veto any alternative investment manager candidate that did not satisfy a team's review. Among other things, this review may include evaluation of the manager's policies and procedures regarding valuation.

- *Legal Documents Review.* The staff observed that most advisers included a review of legal documents as part of their due diligence process. In addition, the staff observed that some advisers focused greater attention on legal reviews in an effort to detect legal document risk. Document risk may include unique contractual provisions or preclusions that present unique risks to investors, such as the inability of an investor to liquidate its investment upon certain events in the alternative investment fund. Legal analysis, which was generally conducted by

[11] Operational Due Diligence generally focuses on non-investment risk such as business operations risk and its associated control environment, including controls related to managing conflicts.

the adviser's legal staff, may include the review of offering materials, side letters, subscription agreements, and counterparty agreements.

- *Investment Fund Redemption Terms and Liquidity of the Portfolio*. The staff observed that advisers' due diligence teams tended to focus closely on liquidity issues. The staff was informed that this increased attention was likely attributed to managers imposing redemption restrictions on investors during the financial crisis. Specifically, advisers generally assessed the appropriateness of redemption terms in light of the underlying portfolio composition to identify significant mismatches in liquidity. In particular, advisers to alternative investments that invest in other alternative investments appeared to be more sensitive to the liquidity terms of the underlying managers' portfolios to ensure that they corresponded with the liquidity terms of their own alternative investments.

- *Onsite Visit Requirement*. The staff observed that most advisers included onsite visits to managers as part of their investment, risk management, and operational due diligence reviews. Advisers also informed the staff that onsite visits helped due diligence teams: (i) understand the culture of the manager; (ii) detect instances where dominant individuals and inadequate control environments may exist; (iii) and provide increased access to review documents and to speak with the manager's personnel.

- *Audited Financial Statements Review*. The staff observed that, although many advisers have previously received and reviewed the audited financial statements of private alternative investments, some advisers have recently expanded their review of such records. For example, some advisers were reviewing the audited financial statements, among other sources, to identify possible related party transactions and to identify valuation concerns.

### B. Warning Indicators or Awareness Signals for Concern For Advisers

Advisers utilizing some or all of the due diligence methods noted above did so in an attempt to identify certain risk indicators during their investment, operational, and risk management reviews. Some of these indicators, which are noted below, led advisers to conduct additional due diligence analysis, to request that the manager make appropriate changes, or to reject (or veto) the manager or the alternative investment.[12]

#### i. Investment

- Managers that were unwilling to provide requisite transparency regarding portfolio holdings to the adviser;
- Performance returns that did not correlate with known factors associated with the manager's strategy, as described by the manager;
- Lack of clear research and investment processes; and
- Lack of an adequate control environment and segregation of duties between investment activities and business unit controllers (*e.g.*, managers dominating the valuation process).

[12] Staff has observed that, while firms typically have dedicated groups in the areas specified in this section, these groups usually work in close conjunction and have some degree of overlap.

### ii. Risk Management

- Alternative investment portfolio holdings that showed a high concentration in a single investment position, or a heavy concentration in a single sector, for a purportedly diversified investment strategy;
- Manager personnel that appeared to be insufficiently knowledgeable about a sophisticated strategy they were purportedly implementing;
- Manager investment style that appeared to have drifted over time; and
- Investments, as described by the manager, that appeared to be overly complex or opaque.

### iii. Operational

- Lack of a third-party administrator or an unknown/unqualified administrator;
- Use of an auditor that may not have significant experience auditing private investment funds or is an unknown auditor;
- Multiple changes in key service providers, such as auditors, prime brokers, or administrators;
- Concerns identified in audited financial statements such as qualified opinions, related party transactions, or valuation concerns;
- Background checks that revealed unfavorable regulatory history, bankruptcy filings, or serious legal issues of the manager or key personnel;
- Identification of undisclosed potential conflicts of interests, such as compensation arrangements or business activities with affiliates;
- Insufficient operational infrastructure, including an inadequate compliance program; and
- Lack of a robust fair valuation process.

## II. Staff Observations – Compliance With the Advisers Act

During its examinations, in addition to collecting the information about current practices described above, the staff also assessed advisers' compliance with applicable laws, rules and regulations.

### A. Compliance Programs

Advisers are required by Rule 206(4)-7 under the Advisers Act to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and to annually review the adequacy of those policies and procedures and the effectiveness of their implementation. These requirements include: (i) naming a Chief Compliance Officer ("CCO") to administer their programs; (ii) adopting compliance policies and procedures; and (iii) completing annual reviews of the effectiveness of their compliance policies and procedures. Additionally, while typically not incorporated into the advisers' compliance manuals, many of the advisers examined by the staff had written, formal due diligence policies and procedures or guidance in place; those that did not had, at a minimum, some type of informal due diligence framework in place. Below are some areas where material deficiencies or control weaknesses were observed in some of the examinations.

- *Annual Review*. The staff observed that some advisers, for whom investing in or recommending alternative investments was a key portion of their business, did not include in their annual review a review of their due diligence policies and procedures for such investments.

- *Disclosures Made to Clients***.** The staff observed that advisers' disclosures sometimes deviated from actual practices, and that advisers with material deficiencies in their disclosures failed to review disclosures for consistency with fiduciary principles or to describe notable exceptions made to the adviser's typical due diligence process.

- *Marketing Claims***.** The staff observed that some advisers' marketing materials contained information about the scope and depth of the due diligence process that could be misleading or statements that appeared to be unsubstantiated. For example, one adviser overstated the number of research analysts and their average years of experience in the industry.

In addition to material deficiencies, the staff also made the following observations:

- *Policies and Procedures*. The staff observed that advisers were more likely to have due diligence processes that were consistently applied if they adopted written policies and procedures that were detailed and required adequate documentation. These advisers incorporated compliance oversight into their business and operations and were able to use these policies as an internal guide in the selection and monitoring of portfolio investments and their related third-party managers.

- *Oversight of Service Providers.* The staff observed that in some instances, advisers delegated certain responsibilities to third-party service providers. Advisers that did not conduct periodic reviews of their service providers to determine whether the service providers were abiding by the terms of their agreements were more likely to have deficiencies in meeting those responsibilities.

### B. Code of Ethics

All advisers registered with the SEC must adopt and enforce a written code of ethics reflecting the adviser's fiduciary duties to its clients.[13] At a minimum, such codes should set forth the minimum standard of conduct for all "supervised persons" (*i.e.*, employees, officers, directors, and other persons that the adviser is required to supervise) and must address personal securities trading by these persons. The code of ethics that each adviser chooses to adopt and implement should reflect its fiduciary obligations to its clients and the fiduciary obligations of the persons under its supervision, and require compliance with the federal securities laws.

- *Limited offering review*. The staff observed instances in which advisers invested in or recommended a limited offering to their clients, while they also permitted access persons to acquire an interest in that same limited offering but with preferential investment terms (*i.e.*,

[13] Advisers Act Rule 204A-1.

greater liquidity or reduced fees). Such arrangements create a conflict of interest that may influence the adviser's due diligence process to the detriment of clients — the advisory employee receiving the preferential terms may be incentivized by their own financial interests rather than the best interest of advisory clients. Furthermore, the staff identified instances where advisers did not maintain a record of any decision, and the reason supporting the decision, to approve the acquisition of securities by access persons, as required by Rule 204-2(a)(13)(iii).

## III. Conclusion

The staff hopes that this overview of examinations concerning the due diligence practices of advisers will help to support the compliance programs of registrants.

If you suspect or observe activity that may violate the federal securities laws or otherwise result in harm to investors, please notify us at: http://www.sec.gov/complaint/info_tipscomplaint.shtml.

*This Risk Alert is intended to highlight for firms risks and issues that the staff has identified in the course of examinations regarding investment adviser due diligence processes for selecting alternative investments and alternative investment managers. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance, and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.*

UNITED STATES
**SECURITIES AND EXCHANGE COMMISSION**
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS
100 F STREET, NE
WASHINGTON, DC 20549

October 9, 2012

Dear Senior Executive or Principal of a Newly Registered Investment Adviser:[1]

We are sending you this letter to introduce you to the National Exam Program ("NEP"), which is administered by the Office of Compliance Inspections and Examinations ("OCIE") within the United States Securities and Exchange Commission ("Commission"), and to provide you with information about upcoming examinations of certain newly registered investment advisers and the topical areas that may be examined.[2] ***The NEP staff will contact you separately if your firm is selected for an examination.***

## I. Information About the NEP

An investment adviser registered with the Commission has an obligation to comply with the Investment Advisers Act of 1940 (the "Advisers Act") and the rules adopted by the Commission thereunder. OCIE examines registered advisers, including firms that advise private funds, to assess whether they are operating in a manner consistent with the federal securities laws. OCIE administers such examinations through the NEP, which is comprised of staff in the Commission's 11 regional offices and the home office in Washington, D.C. The NEP's mission is to protect investors and maintain market integrity through risk-focused examinations that promote compliance, prevent fraud, monitor risk, and inform policy.

## II. Presence Exams of Certain Newly Registered Investment Advisers

Consistent with our mission and objectives, the NEP is launching an initiative to conduct focused, risk-based examinations of investment advisers to private funds that recently registered with the Commission ("Presence Exams"). The Presence Exams initiative will take place over the next two years and it has three primary phases: engagement; examination; and reporting. Each phase is described further below.

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1 For purposes of this letter, we distinguish an investment adviser as "newly registered" if it registered with the Commission after the definitional and transitional rules under Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 became effective (July 21, 2011). In addition, this letter is specifically directed to senior officers of investment advisers that manage private funds.

2 The Commission, as a matter of policy, disclaims responsibility for any publication or statement by any of its employees. The views expressed herein are those of the staff and do not necessarily reflect the views of the Commission or the other staff members of the Commission.

### A. Engagement Phase

The NEP is engaged in a nationwide outreach to inform newly registered firms about their obligations under the Advisers Act and related rules, the Presence Exams initiative, and OCIE's practice of engaging directly with firms' senior management. As part of our outreach initiatives, the NEP has published compliance outreach materials, staff letters, risk alerts, special studies, speeches, and other documents that are available on the Commission's website.[3] The Commission's website also contains information and links to relevant laws and rules, staff guidance, enforcement cases, and staff issued no-action and interpretive letters (generally from 2001 to present).[4] Some of these resources and their reference links are provided at the end of this letter.[5]

In addition, the Commission's staff engages in compliance outreach for investment advisers through initiatives such as our Compliance Outreach Program. This program is designed to provide senior officers, including Chief Compliance Officers, with a forum to discuss compliance issues, share experiences, engage in discussions with Commission staff, and learn about effective compliance practices. The program features both regional meetings at various locations across the country and national seminars in Washington D.C.

### B. Examination Phase

During the examination phase of the Presence Exams initiative, NEP staff will review one or more of the following higher-risk areas of the business and operations of advisers selected for an examination:[6]

***Marketing***. Investment advisers may utilize marketing materials to solicit new investors or retain existing investors. NEP staff will review marketing materials to evaluate whether the investment adviser has made false or misleading statements about its business or performance record; made any untrue statement of a material fact; omitted material facts; made any statement that is

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[3] In particular, you are encouraged to review the staff's letter to newly registered investment advisers that was sent to your firm when it registered through IARD. For a more detailed overview of the NEP and the issues of focus for the examination staff, see recent speeches by OCIE's Director, Carlo di Florio, and former Deputy Director, Norm Champ.

[4] Staff interpretations and no-action letters provided by the Commission's Division of Investment Management are informal interpretative and advisory assistance and represent the views of persons who are continuously working with the provisions of the Advisers Act. Opinions expressed by the staff, however, are not an official expression of the Commission's views and they do not have the force of law. You may wish to speak with an attorney or a compliance professional about specific provisions and how they apply to your firm.

[5] This letter does not provide a complete description of all of the legal obligations of SEC-registered advisers nor does it provide a comprehensive inventory of resources that may be available.

[6] The books and records of all registered investment advisers are subject to compliance examinations by Commission staff, including the records and reports of any private funds to which investment advisers registered under Advisers Act provide investment advice. If your firm is examined, you are required to provide examiners with access to all requested advisory records that are maintained by your firm (under certain conditions, documents may remain private under the attorney-client privilege).

otherwise misleading; or engaged in any manipulative, fraudulent, or deceptive activities. In addition, NEP staff will review how investment advisers solicit investors for the private funds they manage, including the use of placement agents.

***Portfolio Management.*** An investment adviser has an obligation to act in the best interests of its advisory clients and to identify, mitigate, and disclose any material conflict of interest. NEP staff will review and evaluate investment advisers' portfolio decision-making practices, including the allocation of investment opportunities and whether advisers' practices are consistent with disclosures provided to investors.

***Conflicts of Interest.*** The NEP staff will review the procedures and controls that advisers use to identify, mitigate, and manage certain conflicts of interest within their firms. Some areas of the conflicts of interest that NEP staff will review includes: allocation of investments, fees, and expenses; sources of revenue; payments made by private funds to advisers and related persons; employees' outside business activities and personal securities trading; and transactions by advisers with affiliated parties.

***Safety of Client Assets.*** Registered investment advisers that have "custody" of client assets must take specific measures to protect client assets from loss or theft. NEP staff will review advisers' compliance with the relevant provisions of the Advisers Act and related rules that are designed to prevent the loss or theft of client assets. When obtained, NEP staff also will review independent audits of private funds for consistency with the Advisers Act custody rule.

***Valuation.*** Investment advisers must have effective policies and procedures regarding the valuation of client holdings and assessment of fees based on those valuations. NEP staff will review advisers' valuation policies and procedures, including their methodology for fair valuing illiquid or difficult to value instruments. NEP staff also will review advisers' procedures for calculating management and performance fees, and allocation of expenses to private funds.

If your firm is selected for an examination, after the completion of the on-site portion of the examination, NEP staff may send you a letter indicating that the examination has concluded without findings or a letter that describes the deficiencies identified and asks your firm to undertake corrective action. If serious deficiencies are found, in addition to sending an examination summary letter, NEP staff may refer the problems to the Commission's Division of Enforcement, or to a self-regulatory organization, state regulatory agency, or other regulator for possible action.

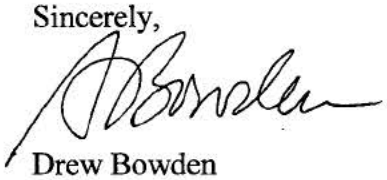
### C. Reporting Phase

At the conclusion of the Examination Phase, the NEP intends to report its observations to the Commission and the public. These observations may include common practices identified in the higher-risk focus areas, industry trends, and significant issues. In sharing examiners' observations from Presence Exams, the NEP staff hopes to encourage firms to review compliance in these areas and to promote improvements in investment adviser compliance programs.

* * *

We hope that this letter was useful in introducing you to the Presence Exams initiative and the examination program generally, and will better acquaint you and your personnel with compliance resources. Should you have any questions regarding this letter, please identify the Commission's regional office that is assigned to your advisory firm and contact any member of NEP management in that office.[7]

Sincerely,



Drew Bowden
Deputy Director

cc: Chief Compliance Officer

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[7] Instructions regarding identifying the Commission's office applicable to your firm are provided in the attached "Additional Information: Reference Materials" guide in the section titled "Information Regarding the NEP and Examinations."

**Additional Information: Reference Materials**

You may find the following non-exclusive list of informational sources to be helpful. Items referenced by a "✓" below are highlighted in the letter.

Information About the Advisers Act

- The Advisers Act and rules are available on the Commission's website at http://www.sec.gov/divisions/investment.shtml).

- Overview of the Regulation of Investment Advisers (April 2012), available on the Commission's website at http://sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf

- SEC-Staff Issued Interpretive Guidance and Studies, available on the Commission's website at http://www.sec.gov/divisions/investment.shtml.

✓ Information for Newly-Registered Investment Advisers, available on the Commission's website at http://www.sec.gov/divisions/investment/advoverview.htm.

Information Regarding the NEP and Examinations

- Overview of Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (February 2012), available on the Commission's website at http://www.sec.gov/about/offices/ocie/ocieoverview.pdf

- Examination Brochure, available on the Commission's website at http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.

- NEP website, available at http://www.sec.gov/about/offices/ocie.shtml.

✓ Listing of local Commission office (contact information for senior examination staff) is available at http://www.sec.gov/about/offices/ocie/ocie_org.htm. The Commission's regional office designated for an adviser can be found by first identifying the adviser's Principal Office and Place of Business on its Form ADV (as used in: Form ADV, Part 1A, Instructions, Items 1 and 2; Schedule D; Form ADV-W, Item 1) and then identifying the Commission's regional office assigned to that state jurisdiction (which can be found at http://www.sec.gov/contact/addresses.htm).

Information Relevant to the Higher-Risk Topical Areas

✓ Speech by Commission Staff Carlo di Florio, "Address at the Private Equity International Private Fund Compliance Forum" (May 2, 2012), available on the Commission's website at http://sec.gov/news/speech/2012/spch050212cvd.htm#_ftnref2.

- ✓ Speech by Commission Staff Norm Champ, "What SEC Registration Means for Hedge Fund Advisers" (May 11, 2012), available on the Commission's website at http://sec.gov/news/speech/2012/spch051112nc.htm.

Information Regarding the Role of Senior Management in Compliance and Ethics

- Speech by Commission Staff Carlo di Florio, "The Role of Compliance and Ethics in Risk Management" (October 17, 2011), available on the Commission's website at http://www.sec.gov/news/speech/2011/spch101711cvd.htm.

- Speech by Commission Staff Stephen M. Cutler, "Second Annual General Counsel Roundtable: Tone at the Top: Getting it Right" (December 4, 2004), available on the Commission's website at http://www.sec.gov/news/speech/spch120304smc.htm.

Information About the Compliance Outreach Program

- Information about the Compliance Outreach Program for investment advisers and any scheduled events is available at http://www.sec.gov/info/complianceoutreach_ia-funds.htm.

Historical Observations by Commission Staff Regarding Hedge Funds

- Commission Staff report regarding the "Implications of the Growth of Hedge Funds" (September 2003), available on the Commission's website at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

THE WALL STREET JOURNAL.



http://www.wsj.com/articles/blackrock-to-pay-12-million-penalty-for-failing-to-disclose-conflict-of-interest-1429551559

MARKETS (HTTP://WWW.WSJ.COM/NEWS/MARKETS)

# BlackRock to Pay $12 Million Penalty for Failing to Disclose Conflict of Interest

Portfolio manager founded oil-and-gas company, while overseeing energy investments


The SEC's order found BlackRock knew and approved of Mr. Rice's investment and involvement with Rice Energy as well as the joint venture, but failed to disclose this conflict of interest to either the boards of the BlackRock registered funds or its advisory clients. *PHOTO: BLOOMBERG NEWS*

By **KIRSTEN GRIND** and **JASON ZWEIG**

Updated April 20, 2015 6:21 p.m. ET

Giant money manager BlackRock Inc. agreed to pay the Securities and Exchange Commission $12 million to settle claims that it failed to tell clients about a conflict between a fund manager's private holdings and portfolios he supervised for BlackRock clients.

Daniel Rice III handled investments in energy companies for certain BlackRock funds

when he founded oil and natural gas producer Rice Energy L.P. in 2007, according to the SEC. Rice Energy later formed a joint venture with publicly traded coal firm Alpha Natural Resources Inc., and by 2011 Alpha was the largest holding in Mr. Rice's BlackRock Energy & Resources Portfolio.

READ MORE

- BlackRock Fund Manager to Leave (http://www.wsj.com/articles/SB10001424052702304441404577480972731325232) (June 21, 2012)
- A Fund Manager's Home Cooking (http://www.wsj.com/articles/SB10001424052702303410404577468622975187312) (June 15, 2012)
- Can 'Skin in the Game' Pose Conflicts? (http://www.wsj.com/articles/SB10001424052702304821304577438511630586748) (June 1, 2012)

The SEC said Monday that BlackRock knew and approved of Mr. Rice's involvement with Rice Energy as well as the joint venture. He committed $50 million to the new firm between 2007 and mid-2010 and became its managing partner while his three sons held high-level positions as chief executive, chief financial officer and vice president of geology, the SEC said.

While BlackRock took some steps to mitigate the conflicts of interest, it failed to disclose them to either the boards of the BlackRock registered funds or its advisory clients, as required by law. The SEC said then-chief compliance officer Bartholomew Battista didn't recommend written policies and procedures to monitor BlackRock employees' outside activities and disclose conflicts of interest to fund boards and advisory clients. Mr. Battista agreed to pay a $60,000 penalty, the SEC said.

The potential conflicts of interest involving Mr. Rice, who didn't return a request for comment Monday, were first reported by The Wall Street Journal in 2012.

As part of the settlement, BlackRock must bring on an independent compliance consultant to do an internal review. "This has been a learning experience for our firm," a BlackRock spokesman said in a statement. New York-based BlackRock is the world's largest asset manager with about $4.8 trillion in assets under management.

BlackRock said it has taken steps to enhance its policies and procedures related to employees' outside business activities. "As a fiduciary for our clients, we take even the appearance of conflicts of interest extremely seriously," the spokesman added.

Mr. Rice left BlackRock in December 2012, and Mr. Battista currently is an adviser to

BlackRock's legal and compliance department and will depart at the end of the year.

Mr. Battista declined to comment through a spoeksman.

**Write to** Kirsten Grind at kirsten.grind@wsj.com and Jason Zweig at intelligentinvestor@wsj.com

International New York Times


Nelson Peltz's Slate Fails to Win DuPont Board Seats


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# *Pension Funds Can Only Guess at Private Equity's Cost*

MAY 1, 2015

Partnership agreements outlining private equity firms' practices are as closely guarded as the recipe for Coca-Cola.

Indeed, when it comes to secrecy, few industries do it better than private equity. To outsiders, the lucrative business of borrowing money, buying companies and hoping to sell them later at a profit is as impenetrable as a lockbox. Rates of return and hidden costs are difficult to identify, even for investors in these deals.

While top-line fees associated with these funds are well known — management typically charges investors 1 to 2 percent of assets and about 20 percent of portfolio gains — many charges are hidden from view. These include transaction fees, legal costs, taxes, monitoring or oversight fees, and other expenses charged to the portfolio companies held in a fund.

Those undisclosed charges are a meaningful drag on returns.

How meaningful? Very, according to a recent report by CEM Benchmarking, a Toronto-based consulting firm specializing in

Curtis M. Loftis Jr., South Carolina's treasurer, has pushed to learn more about private equity fees.
Dale W. Ferrell for The New York Times

Fair Game

By GRETCHEN MORGENSON

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pension fund performance analysis.

It estimated that more than half of private equity costs charged to United States pension funds were not being disclosed.

CEM concluded that the difference between what funds reported as expenses and what they actually charged investors averaged at least two percentage points a year. For a $3 billion private equity portfolio, that would add up to $61 million.

And this estimate, CEM acknowledges, is probably low. It comes from Dutch pension fund data, and Europeans pay far less to private equity firms than pension funds in the United States typically do, investment experts say.

A 2007 academic paper that was updated in 2009 and published in The Journal of Economic Perspectives points to far larger costs in private equity funds. The paper, “Beware of Venturing Into Private Equity,” by Ludovic Phalippou, a professor at the Said School of Business at Oxford, found that the average private equity buyout fund charged more than 7 percent in fees each year.

Some pension beneficiaries may find it shocking how many fees in their funds’ investments are undisclosed. But it does not surprise Curtis M. Loftis Jr., the state treasurer of South Carolina. For years, Mr. Loftis has been pushing for more transparency regarding costs levied on the private equity and hedge fund investments overseen by his state’s $30 billion Retirement System Investment Commission.

“It’s a mammoth undertaking to understand the complexity of these costs, especially in private equity,” Mr. Loftis said in an interview. “We’ve hired a third-party administrator to try to validate fees and expenses, and after more than a year and three months, they still don’t have a handle on them all.”

One reason the South Carolina pension fund’s costs are so difficult to assess is that it relies more heavily than the typical pension fund on

complex investments in hedge funds, real estate and private equity. According to Mr. Loftis, who is a member of the investment commission, those holdings account for 47 percent of the retirement system's assets. That's more than double the 21 percent median holding of such investments by pensions nationwide, according to the National Conference on Public Employee Retirement Systems.

Certainly, these complex and sizable holdings have raised the South Carolina pension fund's expenses. While not a complete assessment, costs identified by the state last year were $468 million, or 1.56 percent of assets. The median pension fund paid 0.57 percent of assets, by comparison.

South Carolina is far ahead of most other states, however, in trying to determine every nickel in fees that it's incurring in its private equity holdings. The state investment commission hired CEM Benchmarking to conduct an analysis; that assignment created the basis for the consulting firm's new study about disclosure failures nationwide.

Mr. Loftis said private equity firms had been able to obscure their costs partly because of fuzzy accounting rules. The Governmental Accounting Standards Board states that investment-related costs should be reported as expenses if they are "separable from investment income and the administrative expense of the pension plan." This, along with the practice of not detailing specific costs for such things as transaction expenses and monitoring fees, essentially lets funds decide which fees are separable, leaving most investors unaware.

J. J. Jelincic, a member of the California Public Employees' Retirement System board since 2010, has often raised the problem of fee transparency in the fund's private equity investments. Mr. Jelincic, who before joining the board was on the Calpers staff for 24 years, said in an interview that being in the dark on fees created problems for the overseers of the $300 billion pension fund.

"You don't think to negotiate on fees that you're not aware you're being charged," he said. "As a trustee I'm really concerned about not knowing what we're paying on private equity. We may be getting a really good deal, we may be getting a really bad deal. I just don't know."

The CEM report also notes that even those cost disclosures provided by many private equity funds are understated. After investors objected to the excessive fees associated with private equity, most firms began to

offset some costs, returning a portion of them to fund holders. But such rebates only give the illusion of a fee reduction, CEM said, because those fees are also being charged to the portfolio companies in the fund, reducing the ultimate value to investors.

"There is not a broad consensus within the industry on what is a cost," said Mike Heale, a principal at CEM Benchmarking. "Clearly we think there should be disclosure and standardized reporting on everything that the investor doesn't get to keep."

The new scrutiny on secret fees in private equity is more than welcome, Mr. Loftis said. But his experience suggests that private equity firms won't open up more without a tough fight.

"South Carolina has come a long, long way," Mr. Loftis said. "But the average pension plan out there does not have a guy like me hounding them. I wish every treasurer would speak up or every investment commission would speak up. Every pension plan in the nation is paying too much, and it's being hidden."

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A version of this article appears in print on May 3, 2015, on page BU1 of the New York edition with the headline: Hidden Fees Take a Toll on Pensions. Order Reprints | Today's Paper | Subscribe

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# Speech by SEC Staff: Address at the Private Equity International Private Fund Compliance Forum

**Carlo V. di Florio**

***Director, Office of Compliance Inspections and Examinations***
***U.S. Securities and Exchange Commission***

New York, NY

May 2, 2012

Q1. Thanks for being with us Carlo. As everyone here is aware, the deadline has now passed for advisers to large private equity firms to register with the SEC. Can you discuss what the agency is doing to prepare for the nearly 4000 private fund advisers that are registered with the Commission?

Let me begin by thanking you for inviting me to speak to you today on important topics of concern to private equity fund advisers, many of whom are newly registered with the Commission as required under the Dodd-Frank Act. We in the National Examination Program ("NEP") have shared objectives when it comes to protecting investors, market integrity and capital formation. Many of you have been charged by your firms with bolstering their compliance functions to prepare for registration with the Commission. I salute you for the important work that you are undertaking to promote good risk management, compliance and ethics in the private equity fund sector. My door is always open and I welcome the dialogue and collaboration as we work together to prevent fraud, improve compliance, monitor risk and inform policy. As you know, the views that I express here today are my own and do not necessarily reflect the views of the Commission or of my colleagues on the staff of the Commission.

The Data Profile of New Registrants. This morning I can share with you some new data, as of March 30, 2012, about changes to the population of investment advisers registered with the Commission as a result of the recent deadline for new private fund registrants under Dodd-Frank:

- There are now close to 4000 IAs that manage one or more private funds registered with the Commission, of which 34 per cent have registered since the effective date of the Dodd-Frank Act.
- 32 per cent of all advisers that register with us report that they adviser at least one private fund.
- Of the roughly 4000 registered private fund advisers, 7 per cent are domiciled in a foreign country (the UK is the most significant).
- Registered private fund advisers report that they advise nearly 31,000 private funds with total assets of $8 trillion (16% of total assets managed by all registered advisers).
- Based on available information, of the 50 largest hedge fund advisers in the world, 48 are now registered with the Commission. Fourteen of these are new registrants.
- Of the 50 largest private equity funds in the world, 37 are now registered with the Commission. 18 of these are new registrants.

Examination Strategy. Regarding NEP staff preparations for new registrants, we are identifying the unique risks presented by private equity funds, as well as by hedge funds, based on a number of factors. These include our past examination experience with these types of registrants and staff expertise that we have been developing through hiring and training in anticipation of our new responsibilities. We are also developing information management systems to help us organize and evaluate the new information we will be collecting on private equity firms on new Form PF as well as on Form ADV, to help us identify where and how best to allocate our examination resources across existing and new registrants. We are also working to ensure the integrity of confidential information internally, while also developing processes to ensure that examiners are given access to information that will provide them with a better understanding of an entity and allow for better scoping of exams.

Based on these factors, we have a three-fold strategy. First, we will have an initial phase of industry outreach and education, sharing our expectations and perceptions of the highest-risk areas. This will be followed by coordinated examinations of a significant percentage of new registrants, focusing on highest risk areas of their business, and helping us to risk-rate the new registrants. Finally, we intend to culminate in publication of a series of "after-action" reports on the broad issues, risks and themes identified. All of this will be planned and executed in consideration of other responsibilities of the exam program, fulfilling the NEP mission to improve compliance, prevent fraud, inform policy and monitor industry-wide and firm-specific risks.

Regulatory Expectations. An important part of NEP's examination strategy for private equity advisers is to be clear and transparent about our expectations. Registration with the SEC imposes important obligations on newly registered advisers. Upon registration, advisers to hedge funds must comply with all of the applicable provisions of the Advisers Act and the rules that have been adopted by the SEC. These provisions require, among other things, adopting and implementing written policies and procedures, designating a chief compliance officer, maintaining certain books and records, filing annual updates of Form ADV, implementing a code of ethics and ensuring that advertising and performance reporting complies with regulatory rules. In addition, once registered, advisers become subject to examinations by the SEC.

Some of the compliance obligations that I want to highlight for you include:

1. The "Compliance Rule" requires registered advisers, including hedge fund advisers, to (a) adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and rules that the Commission has adopted under the Advisers Act; (b) conduct a review, no less than annually, of the adequacy of the policies and procedures; and, (c) designate a chief compliance officer who is responsible for administering the policies and procedures.[1]

2. The "Books and Records Rule" requires registered advisers, including private equity advisers, to make and keep true, accurate and current certain books and records relating to the firm's investment advisory business. Generally, most books and records must be kept for five years from the end of the year created, in an easily accessible location.[2]

3. Form ADV Updates—Rule 204-1 of the Advisers Act requires registered advisers to complete and file an annual update of Parts 1A and 2A of the Form ADV registration form through Investment Advisers Registration Depository (IARD). Advisers must file an annual updating amendment to Form ADV within 90 days after the end of the firm's fiscal year. In addition to annual filings, amendments must promptly be filed whenever certain information contained in the Form ADV becomes inaccurate.

4. The "Code of Ethics Rule" requires a registered adviser to adopt a code of ethics which sets forth the standards of business conduct expected of the adviser's supervised persons and must address the personal trading of their securities.[3]

5. The "Advertising Rule" prohibits advertisements by investment advisers that are false or misleading advertising or contain any untrue statements of material fact.[4] Advertising, like all statements made to clients or prospective clients, is subject to the general prohibition on fraud under section 206 of the Advisers Act as well as other anti-fraud provisions under the federal securities laws. In addition to specific regulatory requirements, SEC staff has also indicated its view that, if you advertise performance data, the firm should disclose all material facts necessary to avoid any unwarranted inferences.[5]

Another important dimension to your responsibilities is that investment advisers are "fiduciaries" to their advisory clients – the funds. This means that advisers have a fundamental obligation to act in the best interests of their clients and to provide investment advice in their clients' best interests. Investment advisers owe their clients a duty of loyalty and good faith. Advisers to private equity funds should consider some of the following issues:

Fees/Expenses: As a fiduciary, it is important that private equity advisers allocate their fees and expenses fairly. A firm should clearly disclose to clients the fees that it is earning in connection with managing investments as well as expense allocations between a firm and its client fund. Advisers should ensure the timeliness, accuracy and completeness of such reporting. A firm's disclosure policies and procedures should address the allocation of their fees and expenses. In cases where two funds managed by the same investment adviser co-invest in the same investment vehicle, expenses should be allocated fairly across both funds.

Conflicts of Interest: Private equity fund advisers should identify any conflicts presented by the type and structure of investments their funds typically make, and ensure that such conflicts are properly mitigated and disclosed. Advisers of pooled investment vehicles also have a duty to disclose material facts to investors and prospective investors and failure to do so may constitute fraud.[6]

As I discussed in my presentation at this conference last year, it is useful to think about conflicts in the context of the lifecycle of a private equity fund: The Fund-Raising Stage, the Investment Stage, the Management Stage, and the Exit Stage. Without replicating what I said there, there are a number of conflicts that arise at particular stages of that lifecycle.

For example, in the Fund-Raising Stage there are a number of potential conflicts around the use of third-party consultants such as placement agents, and potential conflicts between the private equity fund manager, the fund or its investors, around preferential terms in side-letters for example. There could also be conflicts over how the fund is marketed, particularly where marketing materials make representations about returns on previous investments.

In the Investment Stage, among other potential conflicts, there are potential opportunities for insider trading. For example, even if the portfolio company has been taken private, a fund manager serving on its board could learn material nonpublic information about public companies that the portfolio company does business with. There may also be opportunities for insider trading when a private equity firm makes an equity investment in a public company. Other examples of potential conflicts at the investment stage include allocation of investment opportunities, and allocation of fees.

In the Management Stage some of the same conflicts described in the investment stage can also arise . There is also the potential for misleading reporting to current or prospective investors on PE fund performance by selectively highlighting only the most successful portfolio companies while ignoring or underweighting portfolio companies that underperform.

Finally, in the Exit Stage, which is typically set so that the fund has a 10-year lifespan, with scope to extend for up to three 1-year periods (subject to investor approval) there are several other potential conflicts. For example, the manager could claim to need more time to divest the fund of any remaining assets, but have an ulterior motive to accrue additional management fees. Issues surrounding liquidity events also raise potential conflicts, and valuation of portfolio assets is again an area of potential concern.

Risk Management: The management of conflicts of interest is just one part of good risk management. Private equity fund advisers should evaluate their risk management structures and processes by asking themselves the following types of questions. 1) Do the business units manage risks effectively at the fund levels in accordance with the tolerances and appetites set by the principals and by senior management of the organization? 2) Are the key control, compliance and risk management functions effectively integrated into the structure of the organization while still having the necessary independence, standing and authority to effectively identify, manage and mitigate risk? 3) Does the firm have an independent assurance process, whether through an internal audit department or a third party performing a comparable function by independently verifying the effectiveness of the firm's compliance, control and risk management functions? 4) Do senior managers effectively exercise oversight of enterprise risk management? 5) Does the organization have the proper staffing and structure to adequately set its risk parameters, foster a culture of effective risk management, and oversee risk-based compensations systems and the risk profiles of the firm?

Q2 You have spoken extensively about the SEC's new strategy with regard to other types of financial institutions of engaging senior management and corporate boards. Can you explain what that means in regard to private equity firms?

We at NEP have been seeking to strengthen channels of communications with senior management across the entire range of entities that we examine, including broker-dealers, fund complexes, clearing agencies, etc. In the context of private equity firms, of course there often may not be the same level or complexity of organization that we might find at, for example, a major broker-dealer. Instead of meeting with senior officers and a board of directors, we might instead meet with the principals, senior investment professionals or general partners of the organization. In all instances, our expectations of who we would want to engage are tailored to the structure and nature of the particular entity. But the purposes and goals of this dialog are largely the same regardless of the titles of the individuals. This helps us to assess the corporate culture and tone being set at the top of organizations. It also furthers our goal of improving compliance, by helping us to determine if the CCO has the full support and engagement of senior management and the principals (or board of directors, if applicable). In addition, this enables us to understand the firm's approach to enterprise-wide risk management – e.g., from the perspective of the board of directors (if one exists) or the principals of the firm, and then from senior management. This engagement also gives us a strong overall context for any examination of the firm. Finally, these types of communications help us indentify risks across the industry or determine areas of focus not just at the firm but similar registrants, to help us better allocate and leverage our resources on the most significant risks.

I believe that this approach is good for us, good for CCOs, and good for the entities that we examine. I hope that you will agree with me that good ethics and risk management is vital to business success, in private equity just as much as in any other are of financial services.

There is another reason why meeting with firms' leadership is especially important in connection with private equity firms. I have said in front of other audiences that an effective risk governance framework includes three critical lines of defense, which are in turn supported by senior management and the board of directors or the principal owners of the firm.

1. The business is the first line of defense responsible for taking, managing and supervising risk effectively and in accordance with laws, regulations and the risk appetite set by the board and senior management of the whole organization.
2. Key support functions, such as compliance and ethics or risk management, are the second line of defense. They need to have adequate resources, independence, standing and authority to implement effective programs and objectively monitor and escalate risk issues.
3. Internal Audit is the third line of defense and is responsible for providing independent verification and assurance that controls are in place and operating effectively.

While I understand that some private equity firms have not traditionally had internal audit functions, I am encouraged to see such functions start to develop, and I hope to see further development of the internal audit function. In the meantime, at firms that lack a robust internal audit function the NEP will place even greater weight on assurance that senior management and the firm's principals are supporting each of the other two levels by reinforcing the tone at the top, driving a culture of compliance and ethics and ensuring effective implementation of risk management in key business processes, including strategic planning, capital allocation, performance management and compensation incentives.

Q3. You mentioned a National Exam Program that will take a more risk-based approach in how it exams registered advisers, can you elaborate on how that will look in practice?

Let me divide this question into two parts: identifying risks to inform which candidates to select for examination, and identifying the scope of individual examinations.

Regarding candidate selection, over the past two years, OCIE has undertaken a comprehensive set of improvement initiatives designed to improve the exam process, break down silos, and promote teamwork and collaboration across the SEC and with other regulatory partners. In particular, OCIE has implemented a National Exam Program, based around a risk-focused exam strategy. In 2011we created a centralized Risk Assessment and Surveillance ("RAS") Unit to enhance the ability of the National Exam Program to perform more sophisticated data analytics to identify the firms and practices that present the greatest risks to investors, markets and capital formation.

This risk-based approach is partly a matter of wanting to use our resources as effectively as possible, and partly a matter of necessity, given that the exam program has only been able to cover a very small portion of the individuals and entities that register with the Commission, even before new registrants such as are represented in this audience came within our purview as a result of the new requirements of the Dodd-Frank Act.

It is not possible for me to discuss very specifically all of the risks we are currently monitoring, but I can give you an overview of how this process works. Generally, we rely on four categories of inputs for risk identification. The first is the National Exam Program itself, this includes the leadership in each program area (the National Associates) and the observations from our 900 examiners across the nation our tips, complaints and referral system, and our RAS Unit. The second is other parts of the Commission, particularly the Division of Risk, Strategy and Financial Innovation, the Enforcement Division's Asset Management Unit, the Office of Market Intelligence, and the Divisions

of Trading and Markets and Investment Management. Third are other regulators, such as sister federal financial regulators, SROs, state regulators, and foreign regulators. Fourth are external sources such as trade groups and news media reports.

This process of collecting and inventorying risks is a continual, real-time process, and feeds into an annual strategic plan for the National Exam Program, as well as mid-year assessments of that plan. Based on the risks identified, we then make a top-down assessment of which firms appear to exhibit these risks. We also make a bottom-up assessment, based on the data available for our registrants, as to which firms exhibit a higher risk profile given their business activities and regulatory history. For example, leveraging data and information provided in filings and reports made with the Commission and the SROs, our staff can develop risk profiles of Registrants, their personnel and their business activities.

This risk-screening process is particularly challenging for us with regard to private equity funds due to the general lack of data in this area. However, there are a number of risk characteristics that we are likely to consider, and we expect that as we gain more experience with this sector of the capital markets we will become more effective in identifying and assessing risks related to private equity. Examples of some basic risk characteristics that we would track include any information from our TCR system, any material changes in business activities such as lines of business or investment strategies, changes in key personnel, outside business activities of the firm or its personnel, any regulatory history of the firm or its personnel, anomalies in key metrics such as fees, performance, disclosures when compared to peers or to previous periods, and possible financial stress or weaknesses.

Regarding the application of risk-based analysis to examination execution, we seek to conduct robust pre-exam work and due diligence, leveraging data from the examination selection process so that we can have focused document requests and interviews that hone in on higher risk areas. The National Exam Program is also working with all areas of the Commission, particularly the Divisions of Investment Management, Enforcement, and Risk, Strategy and Financial Innovation – to use data and data analytics to target specific risk areas.

In general, the fundamental questions that we are seeking to answer in most examinations are these: Is the firm's process for identifying and assessing problems and conflicts of interest that may occur in its activities effective? Is that process likely to identify new problems and conflicts that may occur as the future unfolds? How effective and well-managed are the firm's policies and procedures, as well as its process for creating and adapting those policies and procedures, in addressing potential problems and conflicts?

Some of the risk areas regarding private equity that might be considered during an examination include these:

a. What is the Fund strategy? Does the Fund control portfolio companies or hold only minority positions? Is the strategy to invest with other firms or alone? Does strategy make general sense? Are investments in easily understandable companies?

b. How clear are investor disclosures around ancillary fees (particularly those charged to portfolio companies), management fee offsets and allocation of expenses? How robust are the processes to ensure compliance with those disclosures?

c. Does the firm have a complicated set of diverse products? If so, how are inter-product conflicts managed? These conflicts can arise, for instance, from two products investing in different parts of a deal's capital structure or products competing for deal allocation.

d. What risks are posed by the life cycle of the funds? For example, for funds approaching the end of their life fund raising may be necessary, in which case risks related to claims about the fund's track record and valuation should be in focus. Conversely, a "Zombie" adviser who is unlikely to raise additional capital may be motivated to extract value from its current holdings, in which case risks related to fees, expenses and liquidity would come into focus. For a fund at the beginning of its life cycle, deal allocations between investment vehicles, or other types of favoritism might be a greater focus of concern.

e. How sophisticated and reliable are the processes used by the Fund? Is the valuation process robust, fair and transparent? Are there strong processes for compliance with the fund's agreements and formation documents? Are compliance and other key risk management and back office functions sufficiently staffed? What is the quality of investor communications? What is the quality of processes to ensure conflict resolution in disputes with or among investors?

f. What is the overall attitude of management towards the examination process, its compliance obligations, and towards risk management generally, compared to its peers?

Finally, in our experience with examinations of private funds in the past, we have found that private fund advisers were slightly more likely to have significant findings, be cited for a deficiency, or have findings referred to enforcement, than the non-private fund adviser population. Perhaps this was attributable, at least in part, to the fact that many private fund advisers then, like many of your firms now, were new registrants, and might not have built the compliance systems and controls that other advisers with longer experience as regulated entities had put in place.

Q4. I suspect conflicts of interest is also part of that risk assessment. Coming back to your earlier comments on conflicts of interest, can you elaborate further on what conflicts the agency sees and what firms should do to address them?

Based on our experience with private equity firms to date, I would like to mention two factors that seem to be important sources of conflicts of interest for these firms. First, many conflicts of interest can arise when fund professionals co-invest with their clients. Second, fund professionals taking roles at portfolio companies also create a number of conflicts that we will want to look at. Let me hasten to add that there is nothing inherently wrong with either of these activities. In particular, fund professionals being active in portfolio companies is a part of the PE business model. My point is simply that these activities increase the risk of other conflicts that need to be managed.

From the examinations of private equity firms that we have conducted to date, there are a number of conflicts that we have identified that I can share with you. These include:

a. The profitability of the management company is obviously an important concern for private equity general partners and this creates an incentive to maximize fees and minimize expenses. We have seen instances where expenses that should have been paid by the management company were pushed to the funds and have also seen instances where questionable fees were charged to portfolio companies. In addition, the same manager may be incentivized to be opaque with fee disclosures for fear that fund investors may not see extra fees as being in their best interest and to pursue larger deals which can absorb more fees. While I have no opinion about the merits of a management company choosing to offer equity shares to the public, I would encourage such firms to consider, as part of their risk management process, whether the short term earnings focus of the public equity markets could exacerbate these conflicts.

b. The adviser negotiates more favorable discounts with vendors for itself than it does for the fund;

c. The adviser favors side-by-side funds and preferred separate accounts by shifting certain expenses to its less favored funds;

d. The adviser puts one or more of the funds that it manages into both equity and debt of a company, which traditionally have conflicting interests, especially during initial pricing and restructuring situations;

e. One or more of a private equity firm's portfolio companies may hire a related party to the adviser to perform consulting or investment banking services. This type of conflict may be remediated through strong disclosures, but we have seen instances where disclosures were not very robust;

f. Conflicts between different business lines, where there may be the potential for confidential information to be improperly shared. The traditional means of remediating these types of conflicts is to maintain effective information barriers, but here too we have seen weaknesses in private funds' practices. For example, we have observed instances of weak or nonexistent controls where the public and private sides of the adviser's business hold meetings or telephone conversations regarding an issuer about which the private side has confidential information, or poor physical security during business hours over the adviser's office space such that employees of unrelated financial firms that have offices in the same building could gain access to the adviser's offices.

Q5.I'm sure everyone here would love to be tested on their ability to address those conflicts of interest, but for those who don't, how does a firm stay off your radar? Or if a firm is selected for an exam, how do they, for a lack of better words, end the exam as quickly as possible?

The best way to avoid attracting our attention would be to be very proactive and thoughtful about identifying conflicts, both the ones I have mentioned as well as others that you are aware of, and remediating those conflicts with strong policies, procedures and other risk controls, as well as making sure that your firm has a strong ethical culture from top to bottom. If your firm is selected for an examination, things are certain to go better if you are prepared, know how to readily access data that our examiners are likely to want to see, and have your policies and procedures ready to show us. Having strong records to document your due diligence on transactions and on valuations will also help you greatly. It will also be enormously helpful to you and to us if you can show us that you have documented ongoing monitoring and testing of the effectiveness of your policies and procedures. Finally, it is important to be forthcoming about problems. Nothing could be worse than for us to find a problem, through an examination or through a tip, referral or complaint, that personnel in your organization knew about but tried to conceal.

[1] Rule 206(4)-7. See also the adopting release, Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2004, 68 Fed. Reg. 74,714 (Dec. 17, 2003), for a full discussion of the "Compliance Rule."

[2] Rule 204-2.

[3] Rule 204A-1.

[4] Rule 206(4)-1.

[5] Information for Newly-Registered Investment AdvisersInformation Sheet, available at http://www.sec.gov/divisions/investment/advoverview.htm

[6] Rule 206(4)-8.

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SPEECH

# Spreading Sunshine in Private Equity

**Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations**

**Private Equity International (PEI), Private Fund Compliance Forum 2014**
**New York, NY**

**May 6, 2014**

## Introduction

Good morning, and thank you very much for that kind introduction. *Before I begin, I'll remind you that the Securities and Exchange Commission disclaims responsibility for any statement or private publication by any of its employees, including me. The views expressed here are my own and do not necessarily reflect the views of the Commission, the Commissioners, or of other members of the staff.*

I want to thank Private Equity International for giving me the opportunity to speak with you at an interesting moment in private equity regulation.[1]

According to at least one industry source,[2] since the beginning of the millennium, the private equity industry's assets under management, defined as the uncalled capital commitments plus the market value of portfolio assets, have increased year after year. With the industry-wide portfolio value increasing steadily, and dry powder remaining around the $1 trillion mark, private equity assets under management are higher than they've ever been at just under $3.5 trillion as of June 30, 2013.

In addition, over the last two years, many of your firms have registered with the Commission and are operating as regulated

entities. I am hopeful that regulation will have a positive effect on your firms and your industry. Intelligent regulation can enable an asset class to grow by increasing investor confidence in investment models, programs, and products, including those offered by private equity firms.

Within OCIE, we have been sharpening our understanding of the private equity industry and our strategies to engage with you to fulfill our important mission to protect investors and the integrity of our markets. I want to take this opportunity to speak today to share where OCIE is in its efforts to engage with the private equity industry and also to share some insights we have learned from the examinations of private equity advisers we have conducted over the last two years.

## OCIE and Presence Exams

OCIE consists of approximately 900 examiners who go out into the world and directly engage with registrants for the purpose of collecting information for the Commissioners and our colleagues on the staff. We are the "eyes and ears" of the Commission. We are responsible for conducting examinations of more than 25,000 registrants, including approximately 11,000 registered investment advisers, of which at least 10% provide services to at least one private equity fund.

We are well prepared and equipped to conduct these exams. Many of our examiners have conducted private equity exams. We have also added individuals with private equity expertise to our team. We maintain a specialized working group of private equity experts across the Commission, who help us identify issues, develop examination modules, evaluate exam findings, and conduct training. You may have also seen that we are forming a special unit of examiners, who will focus on leading examinations of advisers to private funds.

### Presence Exam Initiative

The Presence Exam Initiative is an important part of our strategy to engage with the private equity industry. The initiative commenced in October 2012 and is nearly complete. As the name suggests, we designed the initiative to quickly establish a presence with the private

equity industry and to better assess the issues and risks presented by its unique business model. We began by reaching out to the industry, publishing letters, and appearing at events like this to share information about regulatory obligations and to be as transparent as possible about where we see risks and where we therefore intended to probe, to test, and to ask questions during examinations.

Some questioned why we would show our hand in this way, to which there's a simple and sensible answer. We believe that most people in the industry are trying to do the right thing, to help their clients, to grow their business, and to provide for their owners and employees. We therefore believe that we can most effectively fulfill our mission to promote compliance by sharing as much information as we can with the industry, knowing that people will use it to measure their firms and to self-correct where necessary. Put another way, we are not engaged in a game of "gotcha."

Which reminds me of a story and formative experience. Many, many years ago, I had the pleasure of serving on the Ocean City, Maryland beach patrol. As a new guard, or a "green bean" as we were called, I was assigned to apprentice with a sun-worn, grizzled veteran. One of the first things he explained to me was that because the Beach Patrol measured "pulls," or how many endangered swimmers a guard pulled from hazard, there were some guards who would watch idly while swimmers, through ignorance or neglect, swam themselves into danger, so the guard could jump from the stand and save them. My mentor explained the more effective, responsible approach was to work hard to prevent swimmers from getting into trouble in the first place. He encouraged me to hop off my stand, to speak with swimmers, and to warn them while they were still near shore or a safe distance from a jetty or riptide. The most effective guard, he explained, should rarely have to make a pull.

The same principle was behind our Presence Exam strategy and much of what we do every day, and it's behind the information I am sharing today, some of which is not flattering. I share it not to embarrass or to wag a finger, but to educate so all of the good people in attendance (or reading this speech) can test for and, if necessary, address within

their organizations the types of problems we have seen across the industry.

After engaging with the industry in the initial phase of the Presence Exam Initiative, we commenced examinations. At this point, we have initiated examinations of more than 150 newly registered private equity advisers. We are on track to complete our goal of examining 25% of the new private fund registrants by the end of this year. Based on the feedback we have received, we believe the initiative has been effective and well received. (I welcome your candid feedback in this regard, whether it is consistent with, or contradicts, our belief.) The exams we have conducted to date have also led to some interesting insights, which I'll discuss in a moment.

## Trends in Private Equity Industry

Many people ask how we determine our private equity exam priorities and risk areas. For starters, we analyze the incentives created by various industry structures and trends and use that analysis to determine where compliance failures are most likely to occur. We conduct exams, test our hypotheses, and learn. As the industry structures and trends shift, so too does our view of compliance risks.

### Inherent Risks in Private Equity

When we look at the private equity business model, we see some risks and temptations that are not present in the more common adviser model where an adviser buys and sells shares of publicly traded companies.

A typical buy-side adviser uses client funds to buy shares in a publicly traded company. The adviser can vote proxies and may engage with management and the board up to point ... but absent taking some extraordinary steps, the adviser's ability to influence or control the company is generally constrained. If the adviser jumps through the hoops necessary to attempt to influence or control the company, and accumulates (alone or with others) enough shares to pull it off, its control and the changes it intends to make are generally visible to its clients and the public at large.

The private equity model is very different. A private equity adviser typically uses client funds to obtain a controlling interest in a non-publicly traded company. With this control and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend. For example, the private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services ... or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company ... or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.

We have seen that these temptations and conflicts are real and significant.

Next, I'd like to identify some aspects of the industry that not only make it difficult to mitigate these risks, but also may enable them to flourish.

**Limited Partnership Agreements**

General Partners often point to the heavily negotiated and voluminous limited partnership agreement as a source of investor protection. But we've seen limited partnership agreements lacking in certain key areas.

Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors. Poor disclosure in this area is a frequent source of exam findings. We've also seen limited partnership agreements lacking clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.

Finally, and most importantly, we see that most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager. Of course, many managers voluntarily provide important information and disclosures to their investors, but we find that broad, imprecise language in limited partnership agreements often leads to opaqueness when transparency is most needed.

### Lack of Transparency

Lack of transparency and limited investor rights have been the norm in private equity for a very long time. While investors typically conduct substantial due diligence *before* investing in a fund, we have seen that investor oversight is generally much more lax *after* closing.

There could be many reasons for this. Investors may not be sufficiently staffed to provide significant oversight of managers. When they are, and even when they conduct rigorous due diligence up front, they often take a much more hands-off approach after they invest their money and funds are locked up. This is especially true when managers have completed their investment period and the investor does not plan to reinvest. There is a high cost to initiating action among limited partners, especially after their capital has been substantially drawn and when there are many investors in a fund, who are difficult to organize or even identify. Or, there may be a mistaken belief that auditors will provide sufficient oversight to protect investors' interests.

So … when we think about the private equity business model as a whole, without regard to any specific registrant, we see unique and inherent temptations and risks that arise from the ability to control portfolio companies, which are not generally mitigated, and may be exacerbated, by broadly worded disclosures and poor transparency.

### Industry Trends

Finally, in OCIE we see some current developments in the industry that appear to be generating pressure on private equity firms and heightening the risk of a misalignment of interests between advisers

and investors. Although the capital raising market has substantially improved since the lowest points in 2009 and 2010, there still appears to be a consolidation and shake out in the industry. This has created several issues.

First, we continue to see "zombie" advisers, or managers that are unable to raise additional funds and continue to manage legacy funds long past their expected life. These managers are incentivized to continue to profit from their current portfolio even though that may not be in the best interest of investors. These managers may increase their monitoring fees, shift more expenses to their funds or try to push the envelope in their marketing material by increasing their interim valuations, sometimes inappropriately and without proper disclosure.

Next, consolidation will also produce some winners — advisers that are able to rapidly grow their assets under management — and we are seeing the emergence of larger managers, which have additional and different business lines, products, and stake holders than an adviser that only manages private equity funds. Most of these managers have grown up managing purely private equity vehicles, and some are having difficulty adjusting to the complexities and inherent conflicts of interest of their new business model.

OCIE's experience is that complexity and rapid growth have created governance and compliance issues that should be addressed as these firms mature and evolve. For example, we have seen that much of the growth in private equity is not coming from the traditional co-mingled vehicles but from separate accounts and side-by-side co-investments. These accounts, which invest alongside the main co-mingled vehicle, are often not allocated broken deal expenses or other costs associated with generating deal flow. This may be occurring because the rapidly growing adviser has not yet updated its policies and procedures to be able to handle separate accounts or because the adviser may not have invested sufficient capital in the back-office to be able to perform a proper allocation. Whatever the reason, it's clear that in many instances these firms' compliance functions are not growing as quickly as their businesses.

Also, despite the relatively successful performance of the private equity industry, we have observed returns begin to compress and

converge. As a result, fewer managers will be able to overcome their preferred return and collect carried interest, which heightens the risk that managers may attempt to make up that shortfall in revenue by collecting additional fees or shifting expenses to their funds. As I'll discuss shortly, this has been a significant issue that OCIE has seen in our private equity registrant population.

## Examination Observations

With some of these industry dynamics as a backdrop, I'll discuss a few of the observations from the more than 150 exams of private equity advisers that we have conducted to date.

### Expenses

By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.

This is a remarkable statistic. Historically, the most frequently cited deficiencies in adviser exams involve inadequate policies and procedures or inadequate disclosure. This makes sense because virtually any primary deficiency can be coupled with a secondary deficiency for failing to maintain policies and procedures to prevent the primary deficiency or failing to disclose the primary deficiency to clients. And the deficiency rate for these two most commonly cited deficiencies usually runs between 40% and 60% of all adviser examinations conducted, depending on the year. So for private equity firms to be cited for deficiencies involving their treatment of fees and expenses more than half the time we look at the area is significant.

Some of the most common deficiencies we see in private equity in the area of fees and expenses occur in firm's use of consultants, also known as "Operating Partners," whom advisers promote as providing their portfolio companies with consulting services or other assistance that the portfolio companies could not independently afford. The Operating Partner model is a fairly new construct in private equity and

has arisen out of the need for private equity advisers to generate value through operational improvements. Many limited partners view the existence of Operating Partners as a crucial part of their investment thesis when they allocate to private equity funds, largely because the Operating Partner model has proven to be effective.

Many of these Operating Partners, however, are paid directly by portfolio companies or the funds without sufficient disclosure to investors. This effectively creates an additional "back door" fee that many investors do not expect, especially since Operating Partners often look and act just like other adviser employees. They usually work exclusively for the manager; they have offices at the manager's offices; they invest in the manager's funds on the same terms as other employees; they have the title "partner"; and they appear both on the manager's website and marketing materials as full members of the team. Unlike the other employees of the adviser, however, often they are not paid by the adviser but instead are expensed to either the fund or to the portfolio companies that they advise.

There are at least two problems with this. First, since these professionals are presented as full members of the adviser's team, investors often do not realize that they are paying for them *a la carte,* in addition to the management fee and carried interest. The adviser is able to generate a significant marketing benefit by presenting high-profile and capable operators as part of its team, but it is the investors who are unknowingly footing the bill for these resources. Second, most limited partnership agreements require that a fee generated by employees or affiliates of the adviser offset the management fee, in whole or in part. Operating Partners, however, are not usually treated as employees or affiliates of the manager, and the fees they receive therefore rarely offset management fees, even though in many cases the Operating Partners walk, talk, act, and look just like employees or affiliates.

Another similar observation is that there appears to be a trend of advisers shifting expenses from themselves to their clients during the middle of a fund's life — without disclosure to limited partners. In some egregious instances, we've observed individuals presented to investors as employees of the adviser during the fundraising stage

who have subsequently being terminated and hired back as so-called "consultants" by the funds or portfolio companies. The only client of one of these "consultants" is the fund or portfolio company that he or she covered while employed by the adviser. We've also seen advisers bill their funds separately for various back-office functions that have traditionally been included as a service provided in exchange for the management fee, including compliance, legal, and accounting — without proper disclosure that these costs are being shifted to investors.

More commonly, we see advisers using process automation as a vehicle to shift expenses. For instance, it is becoming commonplace to automate the investor reporting function. Where, in the past, adviser employees compiled portfolio company information and distributed reports, now a software package captures operating data directly from the portfolio companies and distributes investor reports automatically. There's certainly nothing wrong with this development that makes private equity advisers more efficient. But the costs of this efficiency gain, including the cost of the software and its implementation, are often borne not by the adviser, who is responsible for preparing and delivering the reports, but by investors when the funds are charged, contrary to the reasonable expectation of the limited partners under a fair reading of the limited partnership agreement.

**Hidden Fees**

The flipside of expense-shifting is charging hidden fees that are not adequately disclosed to investors.

One such fee is the accelerated monitoring fee. Monitoring fees, as most limited partners know, are commonly charged to portfolio companies by advisers in exchange for the adviser providing board and other advisory services during the portfolio company's holding period. What limited partners may not be aware of is that, despite the fact that private equity holding periods are typically around five years, some advisers have caused their portfolio companies to sign monitoring agreements that obligate them to pay monitoring fees for ten years … or longer. Some of these agreements run way past the

term of the fund; some self-renew annually; and some have an indefinite term. We see mergers, acquisitions, and IPOs triggering these agreements. At that point, the adviser collects a fee to terminate the monitoring agreement, which the adviser caused the portfolio company to sign in the first place. The termination usually takes the form of the acceleration of all the monitoring fees due for the duration of the contract, discounted at the risk-free rate. As you can imagine, this sort of arrangement has the potential to generate eight-figure, or in rare cases, even higher fees. There is usually no disclosure of this practice at the point when these monitoring agreements are signed, and the disclosure that does exist when the accelerations are triggered is usually too little too late.

There are other troubling practices in the hidden fee arena including:

- Charging undisclosed "administrative" or other fees not contemplated by the limited partnership agreement;
- Exceeding the limits set in the limited partnership agreement around transaction fees or charging transaction fees in cases not contemplated by the limited partnership agreement, such as recapitalizations; and
- Hiring related-party service providers, who deliver services of questionable value.

The Commission's Enforcement Division recently filed a case[3] against a Manhattan-based private equity manager, alleging the misappropriation of more than $9 million from investors in a private equity fund. The investigation is still continuing, but the Enforcement staff obtained an emergency court order to freeze assets and alleged that the manager had schemed with a longtime acquaintance to set up a sham due diligence arrangement. The manager is alleged to have used fund assets to pay fees to a front company controlled by his acquaintance. The fees received by the front company were supposed to be used to conduct due diligence for the fund on potential investments. Instead, the money was allegedly kicked back (indirectly) to the private equity manager, and he is alleged to have spent it for other purposes. For example, he allegedly paid hefty

commissions to third parties to secure investments from pension funds. He also allegedly rented luxury office space and used the funds to project the false image that his firm was a thriving international private equity operation.

**Marketing and Valuation**

The final set of OCIE's observations I want to discuss have to do with marketing and valuation. Since the private equity fundraising market continues to be tight for some advisers, we expect marketing to continue to be a key risk area even as the overall market improves.

Over the past several years, there has been an industry discussion about the relevance of interim valuations. The industry has argued that since management fees are not based on interim valuations, the role of interim valuations is limited. Last year at this conference, Bruce Karpati, then of the SEC's Enforcement Division, addressed this debate, noting the importance of valuations in fund marketing. Academic studies have supported this thesis, showing that some advisers inflate valuations during periods of fundraising.[4] Valuation, of course, is a clear signal to investors about the health of an adviser's most current portfolio, which may be the most relevant to an investor considering whether to invest in a current offering.

A common valuation issue we have seen is advisers using a valuation methodology that is different from the one that has been disclosed to investors. The Division of Enforcement recently settled a case[5] against a New York-based private equity manager based on allegations that he misled investors and potential investors with respect to the value of a fund-of-funds that he managed. Enforcement alleged that the manager disseminated quarterly reports and marketing materials, which wrongly stated that the valuation of the fund-of-fund's holdings was based on values that were received from the portfolio manager of each of the underlying funds. In fact, the manager allegedly valued the fund's largest investment at a significant markup to the underlying manager's estimated value. He also sent marketing materials reporting an internal rate of return that failed to deduct fees and expenses. That one change in valuation methodology caused a huge change in the interim performance of a fund that was still being

marketed to prospective investors. As a result of the change in valuation methodology, the fund's reported gross internal rate of return was enhanced — in one quarter, from roughly 3.8% to more than 38%.

Some of you may be under the mistaken impression that when our exams focus on valuation, our aim is to second-guess your assessment of the value of the portfolio companies that your funds own … to challenge that a portfolio company is not worth X, but X minus 3%. We are not, except in instances where the adviser's valuation is clearly erroneous.

Rather, our aim and our exams are much more focused. Because investors and their consultants and attorneys are relying on the valuation methodology that an adviser promises to employ, OCIE examiners are scrutinizing whether the actual valuation process aligns with the process that an adviser has promised to investors. Some things our examiners are watching out for are:

- Cherry-picking comparables or adding back inappropriate items to EBITDA — especially costs that are recurring and persist even after a strategic sale — if there are not rational reasons for the changes, and/or if there are not sufficient disclosures to alert investors.
- Changing the valuation methodology from period to period without additional disclosure — even if such actions fit into a broadly defined valuation policy — unless there's a logical purpose for the change. For instance, we have observed advisers changing from using trailing comparables to using forward comparables, which resulted in higher interim values for certain struggling investments. While making such changes is not wrong in and of itself, the change in valuation methodology should be consistent with the adviser's valuation policy and should be sufficiently disclosed to investors.

In addition to valuation, our examiners are reviewing marketing materials to look for other inconsistencies and misrepresentations. Some areas of particular focus are: performance marketing, where projections might be used in place of actual valuations — without proper disclosure; and misstatements about the investment team. We

especially focus on situations where key team members resign or announce a reduced role soon after a fundraising is completed, raising suspicions that the adviser knew such changes were forthcoming but never communicated them to potential investors before closing.

## Developing Compliance Programs

Based on these observations, it's fair to say that there's more work to be done in the private equity industry to bring controls and disclosures in line with existing requirements and investor expectations. As compliance professionals, you and your senior leadership are tasked with ensuring that your firm is not only compliant with the technical requirements of the law, but is also treating its clients and investors fairly, equitably, and in accordance with its status as a fiduciary.

I gave a speech a few weeks ago, where I mentioned the three ways where I see registrants encountering problems with the Commission, clients, plaintiffs' attorneys, and sometimes, criminal authorities: outright fraud, reckless behavior, and conflicts of interest. The most effective defense your firms have against such risks is a strong culture of compliance that is supported by the owners and principals of a firm and reinforced through an independent, empowered compliance department.

It all starts at the top. A compliance department has the best chance of success if management is fully supportive of compliance efforts and provides the CCO with the resources needed to do an effective and thorough job. Additionally, strength and effectiveness of a compliance department is boosted when compliance officers not only understand relevant laws and rules, but are integrated into a firm's business. In OCIE, we've seen that compliance officers, who — for example — participate in weekly deal meetings and in meetings with investors, or who review deal memos, tend to be more effective in spotting issues early and are more respected in their organizations. As a result, we generally see their firms tending to be more compliant.

Invariably, compliance issues will arise at your organizations. Whether those issues develop into larger risks to the firm and investors will in large part depend on whether you are not only empowered to spot those issues but also to raise and to assist in resolving them.

Ultimately, a healthy compliance program should make your firm and the entire private equity industry more attractive to investors.

## Why Is OCIE Focusing on Private Funds?

Before I close, I want to address some questions that I'm often asked: Why is OCIE spending resources on private funds? Investors in hedge funds and private equity funds are "big boys" that can take care of themselves. Why not devote more resources to helping "mom and pop" investors?

I have a few responses.

First, the Private Equity Growth Capital Council ("PEGCC") itself has identified the number one myth about private equity as the myth that private equity only benefits wealthy investors.[6] "Mom and pop" are much more invested in these funds than people realize. PEGCC states it best: "Private equity investment provides financial security for millions of Americans from all walks of life. The biggest investors in private equity include public and private pension funds, endowments and foundations, which account for 64% of all investment in private equity in 2012." To the extent private equity advisers are engaged in improper conduct, it adversely affects the retirement savings of teachers, firemen, police officers, and other workers across the U.S.

Next, the results of our exams indicate that because of the structure of the industry, the opaqueness of the private equity model, the broadness of limited partnership agreements, and the limited information rights of investors, we are perceiving violations despite the best efforts of investors to monitor their investments. They often have little to no chance of detecting the kinds of issues I discussed today on their own. So, if we're not on the job, doing exams in this area and spreading sunshine, these problems — which involve significant sums of money — are more likely to persist.

## Conclusion

In conclusion, we hope that sharing our exam observations of private equity advisers is helpful to investors and enables them to ask more and better questions before investing and after investments are made, and, in particular, to request more and better disclosure about the

fees and expenses that they will pay in addition to the management fee and carried interest.

We also hope that our observations are helpful to the private equity industry. Consider it OCIE hopping down off the beach stand, wading waist-deep into the water, and offering that we see unique risks — riptides and jetties — inherent in your business model. Based on our observations of the controls and disclosures currently in place to mitigate these risks, we advise that you work to strengthen your strokes and pay greater attention and give wider berth, to the potential problems that could harm your clients and your businesses, as well as the private equity industry as a whole.

I believe that if we each do our part to develop an effective regulatory scheme and compliance standard that protects investors and the U.S. financial markets — and also works with your business model — you will see that the additional confidence will allow you to access new markets and to continue to grow the private equity industry, which is a crucial part of the American and global economy.

Thank you.

[1] I would also like to thank the OCIE examiners who so diligently and energetically conducted the exams that form the basis of this talk and especially my colleagues, Elizabeth Blase and Igor Rozenblit, for their substantial and cheerful assistance in preparing these remarks.

[2] 2014 Preqin Global Private Equity Report, at 6, *available at*: https://www.preqin.com/item/2014-preqin-global-private-equity-report/1/8194.

[3] *SEC v. Lawrence E. Penn, III, Michael St. Altura Ewers, Camelot Acquisitions Secondary Opportunities Management, LLC, the Camelot Group International, LLC and Ssecurion LLC*, (Jan. 30, 3014). Press release and complaint available at: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540703682.

[4] *See, e.g.,* Tim Jenkinson, Miguel Sousa, and Rüdiger Stucke, "How Fair are the Valuations of Private Equity Funds?" (Feb. 27, 2013); *see*

*also* Barber and Yasuda, "Interim Fund Performance and Fundraising in Private Equity" (Nov. 18, 2013).

[5] *In the Matter of Brian Williamson*, File No. 3-15430 (Jan. 22, 2014), *available at*: http://www.sec.gov/litigation/admin/2014/33-9515.pdf.

[6] Private Equity Growth Capital Council, "Fact and Fiction," *available at*: http://www.pegcc.org/education/fact-and-fiction/.

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SPEECH

# Private Equity: A Look Back and a Glimpse Ahead

**Marc Wyatt, Acting Director, Office of Compliance Inspections and Examinations**

**New York**

**May 13, 2015**

## I. Introduction

Good morning and thank you very much for the kind introduction.

*Before I begin, I'll remind you that the Securities and Exchange Commission ("SEC or Commission") disclaims responsibility for any statement or private publication by any of its employees, including me. The views expressed here are my own and do not necessarily reflect the views of the Commission, the Commissioners, or of other members of the staff.*

I want to thank Private Equity International for inviting me to speak at this conference and follow up on the speech given to this group last year by Drew Bowden, then the Director of the SEC's Office of Compliance, Inspections and Examinations, which we call "OCIE."

Today, I would like to take a look back since the enactment of Dodd Frank, particularly the last year, and give a glimpse ahead on how we at OCIE anticipate operating going forward in the private equity space.

## II. Recap of Our Activities

To recap, OCIE commenced the Presence Exam Initiative in October 2012 in response to the Dodd Frank provisions requiring the registration of many advisers to private equity funds. We designed the Initiative to quickly establish a presence in the private fund industry and to better assess the issues and risks presented by these unique

business models. OCIE's approach was to be as transparent as possible about what we were doing, about where we see risks and therefore where we intended to place particular focus. We also wanted to share our observations with you so that as compliance professionals you have the opportunity to bolster your compliance programs to meet your firms' unique challenges and risks.

Our observations, which we have communicated to you in various statements and public appearances, came from the more than 150 exams of private equity advisers. As you recall, these exams focused on select areas, including the advisers' collection of fees, allocation of expenses, marketing and valuation. Among other things we discussed expense shifting and hidden fees where disclosure was limited or inadequate. Advisers have an affirmative duty to fully and fairly describe "the deal" to investors, including discussing in a meaningful way how expenses will be assessed and fees will be collected.

**Industry Statistics**

Part of the SEC's mission is to promote capital formation, so I would like to review the underlying data for the private equity industry.

From year end 2011 through Q2 2014, the private equity industry grew by 25% as measured by capital under management or money invested plus dry powder.[1] On a trailing 12 month basis, capital raised by private equity firms increased by over 40% (from $354 billion in Q1 2012 to $503 billion in Q3 2014).[2] Dry powder has increased by approximately 19% (from $1 trillion in December 2011 to $1.2 trillion in September 2014).[3] Deal volume by number of deals increased by approximately 7.5% between the end of 2011 and the end of 2014. Deal value increased by about 36% during that same time.[4]

- There are other statistics worth noting. For instance:
    - The size of funds that are currently being marketed has decreased by about 14% (from $410 million in January 2012 to $355 million in September 2014). This suggests that smaller managers are forming, contrary to industry concerns that the cost of SEC registration and regulation could stifle the formation of smaller managers.[5]

- Interestingly, the average size of the actual funds raised has increased by about 57% (from $316 million in the 12 months ending March 2012 to $497 million in the 12 months ending Q4 2014). To me, this is a reflection of the natural maturing and consolidation of the industry and the preference of some investors, especially large non-US investors, for the brand and the services that larger managers can provide.[6]

Just last year, exits from buyouts surpassed $450 billion, an industry record by a wide margin and the fourth consecutive year where Limited Partners ("LPs") received more distributions than capital calls. [7] While the growth of the industry is a function of the free market, the business cycle, and the robust exit environment, it is not unreasonable to infer that greater transparency is fostering greater trust from investors and helping the industry to evolve and grow in healthy ways.

### B. Enhanced OCIE Expertise in Private Equity

While some skeptics worried that registration would impede capital formation, others worried that the SEC and its examinations program was not prepared for the challenge of regulating a complex asset class.

I am pleased to say that I hear this concern less and less these days because OCIE has been able to very quickly come up to speed on this industry and have proven that we are up to the task.

We did this by adding expertise from outside our agency, investing heavily in staff training and creating groups and structures which promote information sharing and provide continuing education.

Over the past several years, the SEC added individuals with industry experience in particular areas including in private equity, trading, cybersecurity, options, high frequency trading, pricing and valuation. These experts complement OCIE's excellent exam teams by helping to identify industry structures, business challenges, outside pressures and incentives all of which are important inputs in understanding key risk areas. I myself joined the Commission as one of OCIE's senior

specialized examiners focused on examinations of advisers to hedge funds and private equity funds.

With private funds, OCIE has taken another step towards knowledge building and deeper specialization by creating the Private Funds Unit ("PFU") which is dedicated to examining advisers to private funds, including private equity advisers. The Private Funds Unit is based in four of our regional offices where there is a particularly high concentration of private fund registrants. It is composed of experienced examiners who have now developed the pattern recognition necessary to quickly and efficiently execute on OCIE's four pillars, which are to promote compliance, monitor risk, detect fraud, and inform policy.

Led by Igor Rozenblit, a veteran of the private equity industry, the PFU's mission is to apply industry and product knowledge to conduct focused, risk-based examinations using OCIE's limited resources. The Private Funds Unit plays a critical role in targeting and selecting exam candidates, scoping risk areas, executing examinations, and analyzing data gleaned from those examinations. It also works closely with the policy-makers in the Division of Investment Management's Private Funds Group, relaying information learned from exams to help shape policy and identify areas in need of more guidance.

While our Private Funds Unit itself is small, it has an outsized impact on the National Examination Program because exam teams are able to incorporate both PFU members and other experienced exam staff from our regional offices. In this way, the insights and expertise generated by the PFU is dispersed throughout our organization.

The Unit also conducts formal classroom training. PFU members are among the faculty for our new examiner training, and they also conduct formalized, case study intensive training for experienced examiners.

The Private Funds Unit has also taken the lead in reaching out to, and engaging with, the private equity industry. We have now connected with most of the major industry associations and are able to maintain on-going conversations with both General Partners ("GPs") and LPs. We also seek out dialogue with industry and investors at conferences

such as this and often receive direct feedback during exams. We are meeting with investors, individually and in smaller groups, to share our observations and to better understand their perspective on potential risk areas. This dialogue enables these investors to better protect the interests of the teachers, firemen, and policemen they often serve.

### C. Influence beyond Exams

Our efforts in OCIE to build expertise not only help us better execute our examinations but also help us build credibility with all of you. That is important when we try to focus you on what we believe are some of private equity's more important compliance problem areas.

When Drew originally announced the observations from our Presence Exams at last year's forum in the "Spreading Sunshine in Private Equity Speech" (the "Sunshine Speech"),[8] there was industry speculation that our findings would be limited to small, unsophisticated advisers. Others hypothesized that our findings would be generally immaterial or that private equity's sophisticated investor base would already be aware of the practices we were bringing to light.

Since that time, there have been many press articles detailing the breadth and depth of some of the practices contained in the Sunshine Speech. Investors are more focused on fee and expense topics, and the industry is reviewing and often changing the practices highlighted a year ago. This is a positive change.

We have also seen changes in GP disclosure practices. As widely reported in the media, additional disclosures of many private equity advisers included significant modifications in their responses to Part 2A of Form ADV, adding more discussion of fee, expense, and other practices. While this too is a positive change, I want to highlight that disclosure of material changes in terms of post-fund closing on Part 2A of Form ADV alone is usually not a sufficient remedy for absence of disclosure prior to fund closing. Here, I would encourage GPs to engage with their investors to obtain whatever consents are necessary under their existing Limited Partnership Agreements ("LPAs") to reflect current practices.

Through our exams, we have learned that disclosure has also been enhanced on certain private equity websites, such as by more clearly defining the role of Operating Partners. In addition, we observed that more robust disclosures are being made to Limited Partnership Advisory Committees.

In our exams we see that some advisers are changing fee and expense practices. For example, the practice of accelerating monitoring fees when a portfolio company is sold or taken public appears to be falling out of favor and the use of evergreen provisions in monitoring agreements, which often enable advisers to take large monitoring agreement termination payments, appears to be declining. Additionally, the collection of revenues from portfolio companies' use of group purchasing organizations is being better disclosed and contained.

We are encouraged to learn that many advisers are increasingly retaining consultants to evaluate their fee practices and have been revising their practices where issues have been found. We are seeing changes both in current practices and in plans for future funds.[9]

We have also observed increased attention to compliance programs, which is critical because an adviser's compliance program is paramount in the defense against fraud, abuse, negligence, and errors. Among other changes, we are seeing greater resources being devoted to compliance, including the splitting of the CCO function into its own separate role from a combined role with the CFO or General Counsel. Also, private equity CCOs are becoming more integrated into the businesses and have greater visibility into their firm's business model. We believe this often leads to more effective policies and procedures.

### D. Impact on Institutional Investors

We have also seen changes in the limited partner community. Institutional investors have long taken due diligence seriously. Nonetheless many were surprised by some of the practices we discovered. The private equity business is complex with many moving pieces with the adviser frequently controlling operating companies and other entities. At the same time, private equity operations are not

always transparent to investors. This, combined with the fact that many LPs do not have the staff or access to delve as deeply into manager operations as our examiners, may create an environment where bad conduct can occur.

While some of these dynamics are structural and therefore not likely to change significantly, OCIE believes that our examinations have enabled limited partners to better focus their resources and priorities. Some of this focus takes the form of new due diligence procedures. For instance, from OCIE's discussions with institutional limited partners we have observed that operational due diligence, once thought to be unnecessary in private equity, is now taking a greater role at many organizations. And, while access to the top managers and economic terms are still critical factors in private equity manager selection, according to those institutional limited partners, transparency, governance, and access to information have all grown in importance.

## III. There Is Still Room for Improvement

Over the past several years, we in OCIE have worked diligently to identify problem areas and as I just discussed, some progress has been made toward addressing some very important issues. However, there is still room for improvement. Many of the areas that could still be improved are ones that you are very familiar with — fees, expenses, valuation, and co-investment allocation — but some are new.

### A. Expenses and Expense Allocation

By far the most common deficiencies noted by our examiners in private equity relate to expenses and expense allocation. Many managers still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty.

One of the most common and often cited practices in this area involves shifting expenses away from parallel funds created for insiders, friends, family, and preferred investors to the main co-mingled, flagship vehicles. Frequently, operational expenses, broken deal expenses, and even the formation expenses of the side-by-side

vehicle are borne by investors in the main fund. Some of these expense items are small, but some, such as the broken deal expenses of an active fund, can be quite large. This practice can be a difficult for investors to detect but easy for our examiners to test.

### B. Co-Investment Allocation

Another area where we have been dedicating resources is co-investment allocation. We've spoken before about our observation that co-investment allocation was becoming a key part of an investor's thesis in allocating to a particular private equity fund, and over the past year, co-investments have become even more important to the industry.

While most of our co-investment observations have been around policies and procedures, we have detected several instances where investors in a fund were not aware that another investor negotiated priority co-investment rights. Disclosing this information is important because co-investment opportunities have a very real and tangible economic value but also can be a source of various conflicts of interest. Therefore, allocating co-investment opportunities in a manner that is contrary to what you have promised your investors can be a material conflict and can result in violations of federal securities laws and regulations.

Ironically, many in the industry have responded to our focus by disclosing less about co-investment allocation rather than more under the theory that if an adviser does not promise their investors anything, that adviser cannot be held to account. However, the risk in that approach is that such promises are often made anyway, either orally or through email. I believe that the best way to avoid this risk is to have a robust and detailed co-investment allocation policy which is shared with all investors. To be clear, I am not saying that an adviser must allocate its co-investments pro-rata or in any other particular manner, but I am suggesting that all investors deserve to know where they stand in the co-investment priority stack.

### C. Real Estate Advisers

In addition to our focus on traditional private equity, the National Examination Program began utilizing our Private Funds Unit to

systematically look at adjacent asset classes. Specifically, last year, the PFU undertook a thematic review of private equity real estate advisers based on the observation that real estate managers, especially those executing opportunistic and value-add strategies, tended to be much more vertically integrated than traditional private equity managers. After buying a property, it is not unusual for a vertically integrated owner-operator investment adviser to provide property management, construction management, and leasing services for additional fees. We have observed that some managers also charge back the cost of their employees who provide asset management services and their in-house attorneys. The PFU decided to examine the disclosure of such fees and expenses.

While we found that sometimes these ancillary services are indeed not disclosed, a more frequent observation was that investors have allowed the manager to charge these additional fees based on the understanding that the fees would be at or below a market rate. Unfortunately, we rarely saw that the vertically integrated manager was able to substantiate claims that such fees are "at market or lower." We observed a range of behaviors. During some of our exams, we have seen that the manager collects no data to justify their fees at all. Other times, the data is collected informally through calls to other industry participants and is not documented. Or, when the information is collected, what is presented to investors can be misleading. I hope that private equity real estate managers who have promised to provide their investors with "rates at or below market rate" review their benchmarking practices to ensure they can support their claims.

## IV. Glimpse Ahead

As we have gotten to know one another during the past few years, many of you have wondered what the ongoing steady state environment would look like. OCIE has now completed our Presence Exams, which examined 25% of the newly registered *private fund* advisers (including both private equity and hedge funds). The Presence Exams were different then our normal, risk-based, examinations. For example, the Presence Exams typically focused on only two or three key risk areas, while our normal examinations can focus on a larger number of risk areas. Outside of the buyout industry,

the PFU is or will be undertaking exams of real estate private equity advisers, credit advisers, and infrastructure and timber advisers, among others.

We will continue to apply our risk methodology to private equity exam selection. Let me elaborate a bit on what "risk-based" means and how our process may be misperceived by industry. Through our risk-based exam selection process, we identify situations or behaviors which pose significant risk to investors or which, we believe, may violate federal securities laws and regulations. These risk factors and other inputs help determine our exam candidates. A firm may be operating in a key risk area but may have developed policies and procedures which address the related risks. An examination of an adviser, in and of itself, does not imply that we believe that the adviser has committed any securities law violations.

It is reasonable to assume that the next year may bring additional private equity actions by the SEC's Division of Enforcement, and so we anticipate heightened awareness of reputational and headline risk by the investor community. No investor wants to see their manager portrayed negatively in the media. As everyone knows, the Commission has already brought some private equity Enforcement cases.[10] Based on a recent speech titled "Conflicts, Conflicts Everywhere" by Julie Riewe, Co-Chief of the SEC Enforcement Division's Asset Management Unit, we can expect additional Enforcement recommendations involving undisclosed and misallocated fees and expenses as well as conflicts of interest.[11] It's important to understand that we work closely with our colleagues in Enforcement and that there is a natural lag between examination and enforcement activity. The Enforcement staff must take the time that is necessary to make an informed and thoughtful decision as to whether to recommend that the Commission take enforcement action based on the facts and the law. It may take two years or longer between the time an examination uncovers problematic conduct and the public announcement of an enforcement action or settlement.

I have now shared with you some of my thoughts and our current focus areas, but it's worth noting that they are not static. The private equity industry has experienced strong growth in the past few years,

but we all know that private equity markets are cyclical. 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.

Additionally, recent media reports and our own examinations suggest that the private equity industry is developing vehicles to make its funds available to retail and mass affluent investors. While most groups are focusing their efforts on smaller accredited investors, some groups are pushing into the retail market. Certainly as private equity eyes the coveted and untapped retail space, full transparency is essential. It will be particularly important that retail investors understand the fees they are paying, the conflicts that the advisers might face, and other risks inherent in the private equity model. Only through complete and timely disclosure can advisers, as fiduciaries, discharge their obligation to put their clients' and investors' interests ahead of their own.

We will therefore continue to vigilantly study and track the private capital markets and adjust our resources as necessary.

## V. Conclusion

While this has been an interesting year, it is my hope that we can continue to keep a constructive dialogue in order to advance our mutual goal of keeping investors safe and well informed as your industry continues to evolve. Thank you.

[1] 2015 Preqin Global Private Equity & Venture Capital Report — Sample Pages, available at https://www.preqin.com/item/2015-preqin-global-private-equity-venture-capital-report/1/10599.

[2] The Q3 2014 Preqin Quarterly Update: Private Equity, available at https://www.preqin.com/docs/quarterly/pe/Preqin-Quarterly-Private-Equity-Update-Q3-2014.pdf.

[3] *Id.*

[4] Q1 2015 Private Equity-Backed Buyout Deals and Exists (April 1, 2015), available at https://www.preqin.com/docs/reports/Q1-2015-Buyout-Deals-Factsheet.pdf.

[5] Preqin Press Release, "Strong Private Equity Fundraising Continues in 2014, But Capital Concentrated Among Fewer Funds, January 5, 2015, available at https://www.preqin.com/docs/press/PE-Fundraising-Q4-14.pdf.

[6] *Id.*

[7] Bain & Company, Global Private Equity Report 2015, available at http://www.bain.com/bainweb/publications/global_private_equity_report.asp.

[8] Andrew J. Bowden, Director, OCIE, "Spreading Sunshine in Private Equity," May 6, 2014, available at http://www.sec.gov/news/speech/2014--spch05062014ab.html.

[9] *See* Private Equity Manager, "GPs push back on LP data requests," November 12, 2014. *See also* Mark Maremont and Mike Spector, "Blackstone to Curb Controversial Fee Practice," Wall Street Journal, October 7, 2014, available at http://www.wsj.com/articles/blackstone-to-curb-controversial-fee-practice-1412714245.

[10] *See, e.g., In re Lincolnshire Management, Inc.* (Sept. 22, 2014), available at http://www.sec.gov/litigation/admin/2014/ia-3927.pdf; *In re Clean Energy Capital, LLC et al.* (Oct. 17, 2014) (settled), available at http://www.sec.gov/litigation/admin/2014/33-9667.pdf; *In re Brian Williamson* (Aug. 20, 2013) (settled), available at http://www.sec.gov/litigation/admin/2013/33-9443.pdf; and *In re Oppenheimer Asset Management Inc.* (Mar. 11, 2013) (settled), available at http://www.sec.gov/litigation/admin/2013/33-9390.pdf.

[11] Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, "Conflicts, Conflicts Everywhere — Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View, available at http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

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SPEECH

# Speech by SEC Staff: What SEC Registration Means for Hedge Fund Advisers

**Norm Champ**

*Deputy Director, Office of Compliance Inspections and Examinations*
*U.S. Securities and Exchange Commission*

**New York City Bar**

**May 11, 2012**

Thank you for inviting me to speak to you today. I am very pleased to be here. As you know, the views that I express here are my own and do not necessarily reflect those of the Commission or my colleagues on the staff of the Commission.

Today I will cover the following three topics: First, I will briefly discuss the provisions of the Dodd-Frank Act that are applicable to private fund advisers, specifically hedge fund advisers, and what the Commission staff and the National Examination Program have been doing to prepare for these new registrants.[1] Second, I will highlight several key requirements under the Advisers Act as well as briefly discuss some important considerations for newly registered hedge fund advisers.[2] Specifically, I will focus on the following three areas: fees, conflicts of interest and risk management. Third, I will cover certain areas for management at hedge fund advisers to consider.

## Dodd-Frank Requirements for Advisers and the National Examination Program

### Dodd-Frank Requirements

**Registration.** Title IV of the Dodd-Frank Act eliminated the private adviser exemption.[3] These private advisers, including advisers to

hedge funds and private equity funds, are subject to the same registration, regulatory oversight and other requirements, such as examination, that apply to other SEC regulated investment advisers. These new registrants were required to register with the Commission by March 30, 2012.[4]

We at the NEP have been monitoring the Form ADV applications of new advisers as they have been filed. As of early April, there were approximately 4,000 investment advisers that manage one or more private funds registered with the Commission, of which 34% (more than 1,350) registered since the effective date of the Dodd-Frank Act, July 21, 2011. We estimate that this represents a 52% increase in registered private fund advisers; 32% of all advisers currently registered with the Commission report that they advise at least one private fund. Of the registered private fund advisers, approximately 7% (284) are domiciled in a foreign country; most of these (136) are in the United Kingdom. Registered private fund advisers report on Form ADV that they advise approximately 30,000 private funds with total assets of $8 trillion, which is 16% of total assets managed by all registered advisers.

Based on available information, we believe that 48 of the 50 largest hedge fund advisers in the world are now registered with the Commission. Fourteen of these largest hedge fund advisers are new registrants.

**New Reporting Obligations.** Pursuant to the Dodd-Frank Act, the SEC also adopted a rule requiring registered investment advisers (including advisers to hedge funds, private equity funds and liquidity funds) with at least $150 million in private fund assets under management to periodically file a new reporting form, Form PF.[5] The information reported in Form PF will be used by the Financial Stability Oversight Council (FSOC) to monitor risks to the U.S. financial system and by the SEC to conduct risk assessments of private fund advisers. The type of information that is required to be disclosed on Form PF and the frequency of filing depends on whether the investment adviser is an adviser to private equity funds, hedge funds[6] or liquidity funds and a "large private fund adviser," which for a hedge fund adviser is

an adviser with at least $1.5 billion in hedge fund assets under management.[7]

All investment advisers required to file a Form PF must provide basic information in Sections 1a and 1b. Section 1a requires indentifying information about the adviser and all related persons whose data is included, the large trader identification number, if any, the regulatory assets under management and net assets under management broken out by types of funds advised, and any assumptions made in responses to any question in Form PF. Section 1b requires information for each advised fund, including identifying information, gross and net asset values, investor concentration, borrowing and liquidity, and performance. There are also questions regarding a fund's investment in other private funds and parallel managed accounts. Hedge fund advisers must disclose information about investment strategies, identification of significant credit risk, and trading and clearing practices in Section 1c.

Large private fund advisers must provide more detailed information than smaller advisers. Section 2a of Form PF requires that large hedge fund advisers disclose aggregate information regarding their hedge funds, including information regarding exposures by asset class, geographical concentration of investments held by funds and the monthly value of portfolio turnover by asset class. Section 2b requires that registered advisers that are large private fund advisers and advise at least one "qualifying hedge fund," a hedge fund with a net asset value of at least $500 million, disclose information for each qualifying hedge fund relating to fund exposures, portfolio liquidity, unencumbered cash holdings, identification of the fund's base currency, collateral practices with significant counterparties, risk metrics, market risk, concentration of positions, and trading and financing for each such hedge fund.[8]

Most hedge fund advisers must begin filing Form PF following the end of their first fiscal year or fiscal quarter, as applicable, to end on or after December 15, 2012. Hedge fund advisers, with at least $5 billion in assets under management attributable to hedge funds, must begin filing Form PF following the end of their first fiscal year or quarter, as applicable, to end on or after June 15, 2012.

Smaller hedge fund advisers will be required to file only annually within 120 days of the end of their fiscal year. Large hedge fund advisers will be required to file quarterly, within 60 days after the end of each fiscal quarter.

#### National Examination Program's Plan for New Registrants

We at the NEP have been evaluating the unique risks presented by hedge funds and private equity funds based on a number of factors, including our past examination experience with these types of registrants and staff expertise. We are also looking to add staff with expertise in these areas.

We are evaluating the new information that we will be collecting on Form PF to help us identify where and how best to allocate our examination resources across existing and new registrants. We are also working to ensure the integrity of the confidential information internally, while also developing processes to ensure that examiners are given access to information that will provide them with a better understanding of an entity and allow for better scoping of exams.

Our strategy for these new registrants will include (i) an initial phase of industry outreach and education like today (sharing our expectations and perceptions of the highest risk areas), (ii) followed by a coordinated series of examinations of a significant percentage of the new registrants that will focus on the highest risk areas of their business and help us to risk rate the new registrants, and (iii) culminating in the publication of a series of "after action" reports, reporting to the industry on the broad issues, risks, and themes identified during the course of the examinations.

All of this will be planned and executed in consideration of the substantial existing responsibilities of the examination program with the goal, as always, of ensuring that we are optimally allocating our resources to fulfill the OCIE mission to improve compliance, prevent fraud, inform policy, and monitor industry-wide and firm-specific risks.

### Important Considerations for Registered Hedge Fund Advisers

#### Obligations under the Advisers Act

Registration with the SEC imposes important obligations on newly registered advisers. Upon registration, advisers to hedge funds must comply with all of the applicable provisions of the Advisers Act and the rules that have been adopted by the SEC. These provisions require, among other things, adopting and implementing written policies and procedures, designating a chief compliance officer, maintaining certain books and records, filing annual updates of Form ADV, implementing a code of ethics and ensuring that advertising and performance reporting complies with regulatory rules. In addition, once registered, advisers become subject to examinations by the SEC.

Some of the compliance obligations include:

1. The "Compliance Rule" requires registered advisers, including hedge fund advisers, to (a) adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and rules that the Commission has adopted under the Advisers Act; (b) conduct a review, no less than annually, of the adequacy of the policies and procedures; and, (c) designate a chief compliance officer who is responsible for administering the policies and procedures.[9]
2. The "Books and Records Rule" requires registered advisers, including hedge fund advisers, to make and keep true, accurate and current certain books and records relating to the firm's investment advisory business. Generally, most books and records must be kept for five years from the end of the year created, in an easily accessible location.[10]
3. Form ADV Updates—Rule 204-1 of the Advisers Act requires registered advisers to complete and file an annual update of Part 1A and 2A of the Form ADV registration form through Investment Advisers Registration Depository (IARD). Advisers must file an annual updating amendment to Form ADV within 90 days after the end of the firm's fiscal year. In addition to annual filings, amendments must promptly be filed whenever certain information contained in the Form ADV becomes inaccurate.
4. The "Code of Ethics Rule" requires a registered adviser to adopt a code of ethics which sets forth the standards of business conduct expected

of the adviser's supervised persons and must address the personal trading of their securities.[11]

5. The "Advertising Rule" prohibits advertisements by registered advisers that are false or misleading or contain any untrue statements of material fact.[12] Advertising, like all statements made to clients or prospective clients, is subject to the general prohibition on fraud under section 206 of the Advisers Act as well as other anti-fraud provisions under the federal securities laws. In addition to specific regulatory requirements, SEC Staff also has indicated its view that, if you advertise performance data, the firm should disclose all material facts necessary to avoid any unwarranted inferences.[13]

These are just some of the obligations for registered advisers under the Advisers Act and rules thereunder.

**Special Considerations for Hedge Fund Advisers**

It is important to note that investment advisers are "fiduciaries" to their advisory clients—the funds. This means that advisers have a fundamental obligation to act in the best interests of their clients and to provide investment advice in their clients' best interests. Investment advisers owe their clients a duty of loyalty and good faith. Advisers to hedge funds should consider some of the following issues:

**Fees/Expenses:** As a fiduciary, it is important that hedge fund advisers allocate their fees and expenses fairly. A firm should clearly disclose to clientss the fees that it is earning in connection with managing investments as well as expense allocations between a firm and its client funds. Advisers should ensure the timeliness, accuracy and completeness of such reporting. A firm's disclosure policies and procedures should address the allocation of their fees and expenses. Particular caution should be exercised when deals are undertaken among funds under common management and affiliated entities. In cases where two funds managed by the same investment adviser co-invest in the same investment vehicle, expenses should be allocated fairly across both funds.

**Conflicts of Interest:** Hedge fund advisers should identify any conflicts presented by the type and structure of investments their

funds typically make, and ensure that such conflicts are properly mitigated and disclosed. Advisers of pooled investment vehicles also have a duty to disclose material facts to investors and prospective investors and failure to do so may constitute fraud.[14] Examples of such conflicts are an adviser who failed to tell clients that it would receive additional commissions if they switched from one series of a fund to another[15] and an adviser who failed to disclose to clients its investment of client funds in entities in which the advisers' principals had interests.[16] Fee structures can also lead to conflicts of interest. For example, conflicts of interest may arise when an adviser has the incentive to allocate trades to the hedge fund at the expense of affiliated mutual funds because of the opportunity for the investment adviser to earn greater profits from its management of hedge funds.

**Risk Management:** The management of conflicts of interest is just one part of good risk management. Hedge fund advisers should evaluate their risk management structures and processes by asking themselves the following types of questions. 1) Do the business units manage risks effectively at the product and asset class levels in accordance with the tolerances and appetites set by the board and senior management of the organization? 2) Are the key control, compliance and risk management functions effectively integrated into the structure of the organization while still having the necessary independence, standing and authority to effectively identify, manage and mitigate risk? 3) Does the firm's internal audit processes independently verify the effectiveness of the firm's compliance, control and risk management functions? 4) Do senior managers effectively exercise oversight of enterprise risk management? 5) Does the organization have the proper staffing and structure to adequately set its risk parameters, foster a culture of effective risk management, and oversee risk-based compensations systems and the risk profiles of the firm?

### My Ten Suggested Takeaways for Registered Advisers to Hedge Funds

1. **Review your control and compliance policies and procedures annually.** As a new registrant, you should undertake a comprehensive review of your operations to identify any gaps to your control and

compliance policies and procedures. Make sure that they work for your organization. Update them if you have changes in your firm's activities or products. Assign responsibility to specific persons/positions for maintaining the procedures. In addition to reviewing policies and procedures annually, which is required under Rule 206(4)-7, you should periodically test and verify procedures. For example, test and verify your valuation procedures and make sure your firm is consistent and following its procedures, especially for complex or illiquid securities.

2. **Assess and prepare for Form PF requirements.** Form PF may require voluminous data. Hedge fund advisers may find that they do not maintain or collect all of the information that is required. Much of the information may be located in various places throughout the firm and some effort may be required to collect and report the information. Therefore, you need to begin now to identify the sources within the business where the data resides, determine how to best capture such data, collect and compile the data, and assure its accuracy.
3. **Identify risks.** You should identify risk. Brainstorm any factors that create risk exposure for your clients and your firm.
4. **Enhance your expertise.** Make sure your employees are knowledgeable about their work and that you have enough expertise to oversee what goes on. Continue to update and train your employees about new rules and procedures applicable to your firm and its products.
5. **Verify client assets.** Be aware that examiners may verify some or all of your assets and the possibility that the examination staff will reach out to third parties and possibly clients in this process. Make sure your organization has done adequate due diligence in connection with third parties, including consultants and service providers.
6. **Get rid of any silos, identify conflicts.** Get rid of silos and open communication among divisions and offices where appropriate and legally possible. I realize that in some situations barriers between certain areas of a firm are required legally. In particular, identify any situations where your interests may conflict with those of your clients.

Make sure you manage those conflicts and disclose them to your clients.

7. **Provide clear, complete, and accurate disclosure in performance and advertising.** Make sure you've made complete and accurate disclosure about performance, arrangements, fees, affiliates and affiliated transactions. Review marketing documents, client communications and questionnaire responses to ensure information is truthful, accurate and not misleading now that the JOBS Act permits general solicitation. Verify that fees are calculated correctly and accurately disclosed. Make sure you can trust the information, both external and internal, upon which you rely.
8. **Verify portfolio management compliance.** Review client account holdings for appropriateness. Review trades for unusual performance relative to peers and markets. Compare trades to restricted lists and determine if trades were made ahead of publicly available news or research reports.
9. **Address your complaints.** For complaints, make sure your procedures provide adequate instructions on handling them, and follow up to make sure they have been resolved.
10. **Check your IT security.** Check your IT security to ensure that clients' assets and information are not at risk.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. § 80b of the United States Code, at which the Advisers Act is codified, and when we refer to rule 203-1, rule 204(b)-1, rule 204-2, rule 204A-1, rule 204-4, rule 206, rule 206(4)-1, or rule 206(4)-7, or any paragraph of these rules, we are referring to 17 C.F.R. § 275.203-1, 17 C.F.R. § 275.204(b)-1, 17 C.F.R. § 275.204-2, 17 C.F.R. § 275.204A-1, 17 C.F.R. § 275.206, 17 C.F.R. § 275.206(4)-1, or 17 C.F.R. § 275.206(4)-7, respectively, of the Code of Federal Regulations ("C.F.R."), in which these rules are published.

[3] Section 403 of the Dodd-Frank Act. Title IV repealed the "private adviser exemption" contained in section 203(b)(3) of the Advisers Act on which many advisers, including those to many hedge funds, private equity funds and venture capital funds, relied in order to avoid registration under the Advisers Act. The adopting release, *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Release No. IA-3221 (Jun. 22, 2011), 76 Fed. Reg. 42950 (Jul. 19, 2011) is *available at*: http://www.sec.gov/rules/final/2011/ia-3221.pdf.

[4] Rule 203-1(e).

[5] Rule 204(b)-1. The adopting release, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF,* Release No. IA-3308 (Oct. 31, 2011), 76 Fed. Reg. 71128 (Nov. 16, 2011), is *available at*: http://www.sec.gov/rules/final/2011/ia-3308.pdf.

[6] Form PF defines a "hedge fund" generally as any private fund (other than a securitized asset fund) that (a) pays a performance fee or allocation calculated by taking into account unrealized gains (other than a fee or allocation the calculation of which may take into account unrealized gains solely for the purpose of reducing such fee or allocation to reflect net unrealized losses); (b) may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net assets value (including any committed capital); or (c) may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration). Form PF: Glossary of Terms, at 4, *available at* http://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf.

[7] Form PF defines a "large hedge fund adviser" generally as an adviser and its related persons who collectively, have at least $1.5 billion in hedge fund assets under management as of the last day of any month in the adviser's fiscal quarter immediately preceding its most recently completed fiscal quarter. *Id.* at 5.

[8] Form PF defines a "qualifying hedge fund" as one that has a net asset value (individually or in combination with any feeder funds, parallel

funds and/or dependent parallel managed accounts) of at least $500 million as of the last day of any month in the fiscal quarter immediately preceding the adviser's most recently completed fiscal quarter. *Id.* at 8.

[9] Rule 206(4)-7. The adopting release, *Compliance Programs of Investment Companies and Investment Advisers,* Release No. IA-2004, 68 Fed. Reg. 74,714 (Dec. 17, 2003)("Compliance Programs Release"), is *available at* http://www.sec.gov/rules/final/ia-2204.htm

[10] Rule 204-2.

[11] Rule 204A-1.

[12] Rule 206(4)-1.

[13] *Information for Newly-Registered Investment Advisers Information Sheet*, *available at* http://www.sec.gov/divisions/investment/advoverview.htm

[14] Rule 206(4)-8.

[15] *In re Valentine Capital Asset Mgmt*., Release No. IA - 3090, 2010 WL 3791924 (Sept. 29, 2010) (settled administrative proceeding).

[16] *In re Sierra Fin. Advisors, LLC*, Release No. IA - 3087, 2010 WL 3725370 (Sept. 23, 2010) (settled administrative proceeding).

*Modified: May 15, 2012*

**U.S. Securities and Exchange Commission**

# Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports

This is a report of the Staff of the Division of Investment Management of the U.S. Securities and Exchange Commission.

The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

August 15, 2014

## Executive Summary

The Dodd-Frank Act directed the Commission to require registered investment advisers to maintain records and file reports regarding the hedge funds, private equity funds and other private funds they advise. The Commission implemented this aspect of the Dodd-Frank Act in 2011 when it adopted a form (Form PF) that requires certain registered investment advisers that advise private funds to report information to the Commission.

While the primary aim of this Dodd-Frank provision was to create a source of data for the Financial Stability Oversight Council (FSOC) to use in assessing systemic risk, the Commission, as provided by the Dodd-Frank Act, is using the information to support its own regulatory programs, including examinations, investigations and investor protection efforts relating to private fund advisers. The Dodd-Frank Act also required that the Commission report annually to Congress on how it has used the data to protect investors and the integrity of the markets. This is the second annual report submitted to Congress to satisfy this obligation.

During the past year, the Commission's staff has focused its efforts on: (i) utilizing Form PF data in examinations and investigations of private fund advisers; (ii) using Form PF data in the Commission's risk monitoring activities; (iii) providing additional guidance to filers; and (iv) working with other federal regulators and international organizations regarding issues relating to private fund advisers.

Appendix A, attached, contains certain aggregated, non-proprietary census Form PF data.

## I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[1] Section 404 directed the U.S. Securities and Exchange Commission (Commission) to establish reporting requirements for investment advisers to private funds as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk by the Financial Stability Oversight Council (FSOC).[2] The Dodd-Frank Act specifies that such reporting must include certain information about private funds, including but not limited to the amount of assets under management, use of leverage, counterparty credit risk exposure and trading practices for each private fund managed by the adviser.[3] In 2011, the Commission adopted Form PF and Advisers Act rule 204(b)–1 that established filing requirements for private fund advisers regarding information for the assessment of systemic risk.[4]

The Commission is required to submit an annual report to Congress regarding how the Commission has used the data collected regarding private funds under the Dodd-Frank Act to protect investors and the integrity of the markets.[5] This report is being submitted to Congress in satisfaction of that requirement. This is a report of the Staff of the Division of Investment Management and the Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

## II. Background

The Commission adopted Form PF to obtain, on behalf of FSOC, data that FSOC can use to monitor systemic risk in U.S. financial markets. Form PF was designed in consultation with FSOC members and their staffs and provides FSOC and the Commission with important information about the operations and strategies of private funds.[6] Investment advisers registered

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1 Public Law 111-203, 124 Stat. 1376 (2010).

2 Section 404 of the Dodd-Frank Act (codified at Section 204(b) of the Investment Advisers Act of 1940, as amended ("Advisers Act")). FSOC was created pursuant to the Dodd-Frank Act to monitor risks to the U.S. financial system. *See* Dodd-Frank Act sections 111 and 112.

3 Section 404 of the Dodd-Frank Act.

4 *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308 (October 31, 2011), 76 FR 71128 (November 16, 2011) ("Adopting Release"). In 2012, the CFTC adopted rule 4.27 under the Commodity Exchange Act to implement systemic risk reporting requirements for registered commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"); the rule also permits CPOs and CTAs registered with the CFTC that are registered with the Commission as investment advisers to file Form PF with the Commission in lieu of filing certain systemic risk reports with the CFTC. *See* Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 77 FR 11252 (February 24, 2012).

5 Section 404 of the Dodd-Frank Act.

6 To implement the reporting requirements, the Commission developed an electronic filing system, the Private Fund Reporting Depository (PFRD) through which advisers submit the information required by Form PF to the Commission. PFRD is operated under contract with the Financial Industry Regulatory Authority (FINRA) as an extension of the existing Investment Adviser Registration Depository (IARD)

with the Commission that have at least $150 million in private fund regulatory assets under management (RAUM)[7] are required to periodically file Form PF with the Commission. The amount of information required to be reported and the frequency with which Form PF must be filed depend on the amount of the adviser's RAUM and the types of private funds managed.

Most advisers are required to file Form PF once a year, and report only basic information regarding the private funds they advise. This annual filing requirement includes general data such as the types of private funds that an adviser advises (*e.g.*, private equity or hedge funds) and information relating to such funds' size, leverage, types of investors, liquidity and performance. Advisers managing hedge funds also must report information about fund strategy, counterparty credit risk and the use of trading and clearing mechanisms.

Large private fund advisers, however, must provide more detailed information. The content and frequency of this more detailed reporting is different depending on the type of private funds the large adviser manages. For example, advisers with at least $1.5 billion in hedge fund RAUM must file Form PF quarterly and provide aggregate information on their hedge funds' exposures, geographical concentration and turnover by asset class (but not position-level information). In addition, for each Qualifying Hedge Fund (*i.e.*, $500 million or more in net assets), advisers provide additional information. Advisers with at least $1 billion in combined liquidity fund and registered money market fund RAUM must file Form PF quarterly and provide information regarding their liquidity funds' exposures, geographical concentration and turnover by asset class and direct and indirect forms of leverage and liquidity.[8] Advisers with at least $2 billion in private equity fund RAUM must file Form PF annually and provide additional information relating to their private equity funds' use of direct and indirect leverage and investments in financial institutions.

The Dodd-Frank Act provides specific confidentiality protections for proprietary information of private fund investment advisers collected by the Commission on Form PF. Consistent with the enhanced confidentiality provisions established under the Dodd-Frank Act, Commission staff has designed and implemented controls and systems for the handling of Form PF data across the agency. Senior staff members from various Divisions and Offices within the Commission are members of a Steering Committee that is tasked with developing and overseeing a consistent and agency-wide approach to accessing, and the using, sharing, and security of, Form PF data.

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system (the online reporting platform advisers use to register on Form ADV with the Commission). *See* Adopting Release at Section II.E.

[7] RAUM is defined, for a private fund, as the private fund's gross assets plus any uncalled capital commitments. *See* Form PF: Glossary of Terms; *See also* Instruction 5.b for Form ADV: Instructions for Part 1A.

[8] The Commission recently adopted amendments to Form PF to obtain additional information regarding private liquidity funds in conjunction with amendments to rules for registered money market funds. *See* Money Market Fund Reform; Amendments to Form PF, Release No. 33-9616 (July 23, 2014).

## III. How the Commission Uses PF Data

The information collected on Form PF primarily is intended to assist FSOC in its systemic risk monitoring obligations under the Dodd-Frank Act. To that end, the Form PF database was made available to FSOC through the Office of Financial Research (OFR) in 2013, subject to agreement regarding appropriate use and confidentiality protections of Form PF data by OFR.[9]

In addition, the Commission is using information obtained from Form PF in its regulatory programs and investor protection efforts relating to private fund advisers.[10] As more fully discussed below, within the Commission, Form PF data principally is used by the Office of Compliance Inspections and Examinations (OCIE), the Division of Economic and Risk Analysis (DERA), the Division of Enforcement (Enforcement) and the Division of Investment Management (IM). Because of the staggered filing dates tailored to the size of an investment adviser dictating when an adviser must file its Form PF, the Commission has only received two full sets data from its filing population. As the data continues to be filed, Commission staff anticipates enhancing its usage of Form PF data. Census data describing the Form PF filing population can be found in the attached Appendix A.

During the past year, the Commission primarily used Form PF data in examinations of registered investment advisers to private funds. In addition, the Commission utilized Form PF data in its enforcement program regarding private fund advisers. Commission staff also focused its efforts on incorporating Form PF data into the Commission's risk monitoring activities, issuing additional guidance to filers and working with other federal regulators and international organizations regarding issues relating to private fund advisers.

*Examinations and Investigations*

The Commission staff uses Form PF data in its examination and enforcement programs regarding registered investment advisers that manage private funds. Because examination and enforcement matters are generally non-public,[11] the following summarizes how Form PF data has been integrated generally into examination and enforcement matters.

Prior to an examination of a private fund adviser that files Form PF, OCIE staff generally reviews the adviser's Form PF filing as a part of a routine pre-examination evaluation. This review, in conjunction with other data sources, provides OCIE staff with an understanding of the nature of an adviser's business and investment strategy. OCIE staff also generally reviews information contained in the Form PF filing for inconsistencies with other information obtained from an adviser during an examination, such as due diligence reports, pitch books, offering documents, operating agreements and books and records. In addition, OCIE staff typically looks for discrepancies between an adviser's Form PF filing and any publicly-available documents related to the adviser, including the adviser's Form ADV and brochure. In addition to reviewing

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9 OFR was established under the Dodd-Frank Act to support FSOC in fulfilling FSOC's purpose and duties. *See* section 152 of the Dodd-Frank Act.

10 *See* Adopting Release at Section V.A.

11 *See, e.g.,* Advisers Act Section 210(b).

Form PF filings for background and to identify inconsistencies with other documents, OCIE staff also often reviews an adviser's Form PF filing in order to confirm that the investment strategies disclosed to investors match the information contained in the adviser's Form PF filing, particularly with respect to holdings, leverage, liquidity, derivatives and counterparties. After completing this analysis, OCIE staff requests additional documentation from registrants to substantiate or explain any inconsistency or red flag. In some cases, this process may lead to an examination deficiency letter.

Enforcement staff also obtains and reviews the Form PF filings of certain advisers in connection with ongoing investigations. Among other Enforcement staff, the Asset Management Unit (AMU) utilizes Form PF data in investigations of private fund advisers.

*Risk Monitoring*

The Commission has continued to develop the use of Form PF data in its ongoing risk monitoring activities. SEC staff in Washington, DC and in the regional offices access reports generated by DERA that use Form PF data and also access Form PF filings directly to assist in risk monitoring activities.

Last year, DERA continued to develop its suite of proprietary analytical tools (DERA Database) including the incorporation of certain data from Form PF to assist staff in risk monitoring activities. For example, OCIE staff in its Risk Analysis and Surveillance (RAS) group queries the DERA Database to identify advisers engaging in activities implicating particular areas of examination focus (exposures, valuation, high-frequency trading, etc.) and to identify possible red flags at firms that may trigger examinations. OCIE and DERA staff are also developing periodic reports that analyze data across a wide spectrum of filers to help identify trends and possible emerging risks in the private fund industry, while IM's Risk and Examinations Office (REO) is developing internal periodic reports regarding the private fund industry generally and certain market segments. Enforcement's AMU, in partnership with OCIE, IM, DERA and Enforcement's Center for Risk and Quantitative Analytics, has accessed Form PF data to conduct its ongoing Aberrational Performance Inquiry (API). API seeks to identify hedge fund advisers that report aberrational returns relative to certain benchmarks for further investigation, which has resulted in the identification of fraudulent or improper conduct. Staff in OCIE and IM's REO began using Form PF data in engagement meetings with private fund advisers that the staff determines to be strategically important and to inform the Commission staff's general knowledge of the private fund industry. IM, DERA, Enforcement and OCIE staff continue to work to develop additional analytical tools and reports focusing on different types of Form PF data as their familiarity and experience with Form PF data grows.

*Guidance*

IM staff uses Form PF data to inform policy and rulemaking initiatives with regard to private funds. During the past year, IM staff issued additional guidance to Form PF filers regarding a

variety of Form PF issues.[12] This guidance resulted from regular, ongoing meetings with OFR staff to assess data submitted in Form PF filings and engagement with private fund advisers to identify areas in which additional guidance for interpreting the form's instructions would be useful. In an effort to improve data quality, IM staff continues to respond to filer inquiries and contact filers to inform them of anomalous data that may require the submission of curative amendments to their Form PF filings.

*Consultation*

Commission staff uses Form PF data in conjunction with other federal regulators in areas of mutual interest, and in international collaborative efforts regarding private funds and their investment advisers. For example, Form PF reports have been used by Commission staff in connection with its participation in FSOC's systemic risk efforts in the private fund space, including in discussions with other federal regulators. Also, in 2013, as disclosed in last year's annual report, Commission staff provided certain aggregated, non-proprietary Form PF data to the International Organization of Securities Commissions (IOSCO) regarding large hedge funds so IOSCO has a more complete overview of the global hedge fund market for a report that was shared with the Financial Stability Board. In 2014, IM staff updated the same set of Form PF data points and again provided it to IOSCO.

## Conclusion

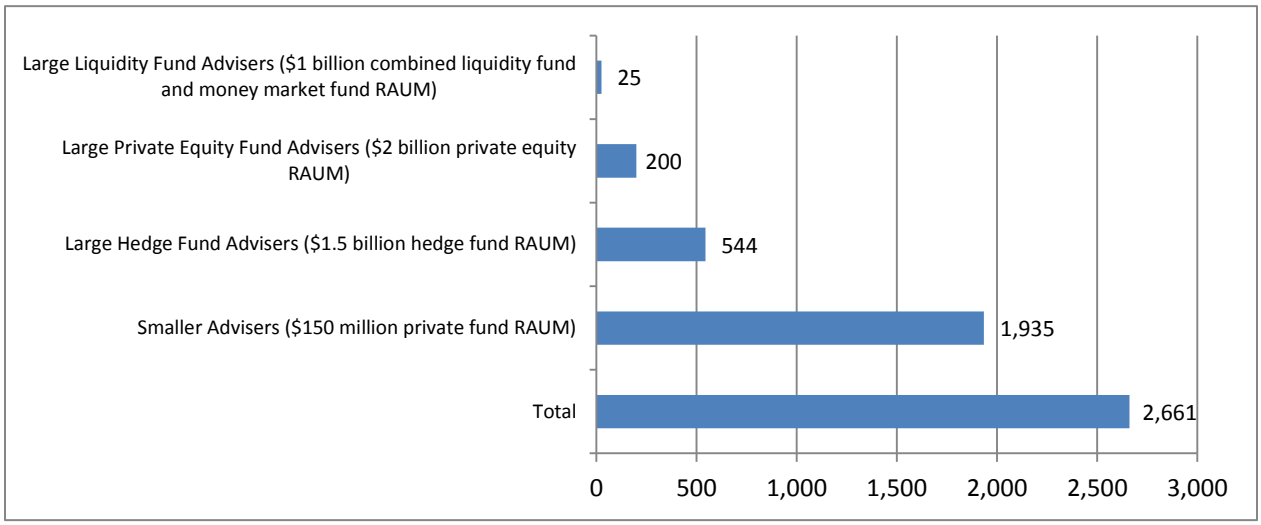
During the past year, the Commission's staff has focused its efforts on: (i) utilizing Form PF data in examinations and investigations of private fund advisers; (ii) using Form PF data in the Commission's risk monitoring activities; (iii) providing additional guidance to filers; and (iv) working with other federal regulators and international organizations in areas of mutual interest relating to private fund advisers.

[12] *See* Updates to Form PF Frequently Asked Questions (February 2014), at http://www.sec.gov/divisions/investment/imannouncements/im-info-2014-1.pdf.

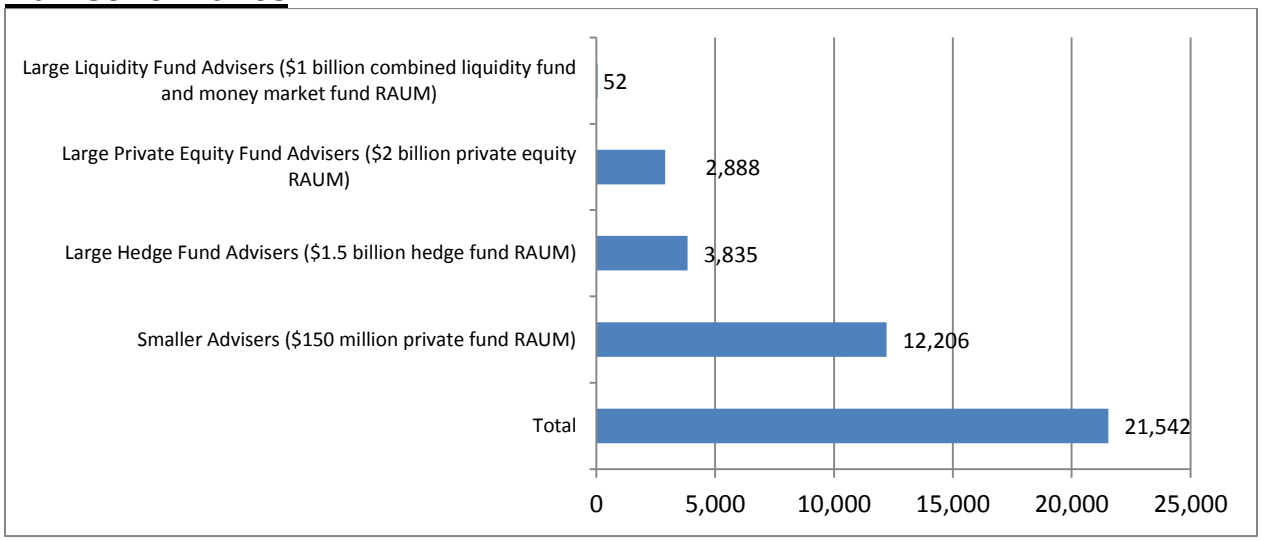
## Appendix A

## Census PF Data as of May 7, 2014.

## Number of Advisers[1]




## Number of Funds[2]

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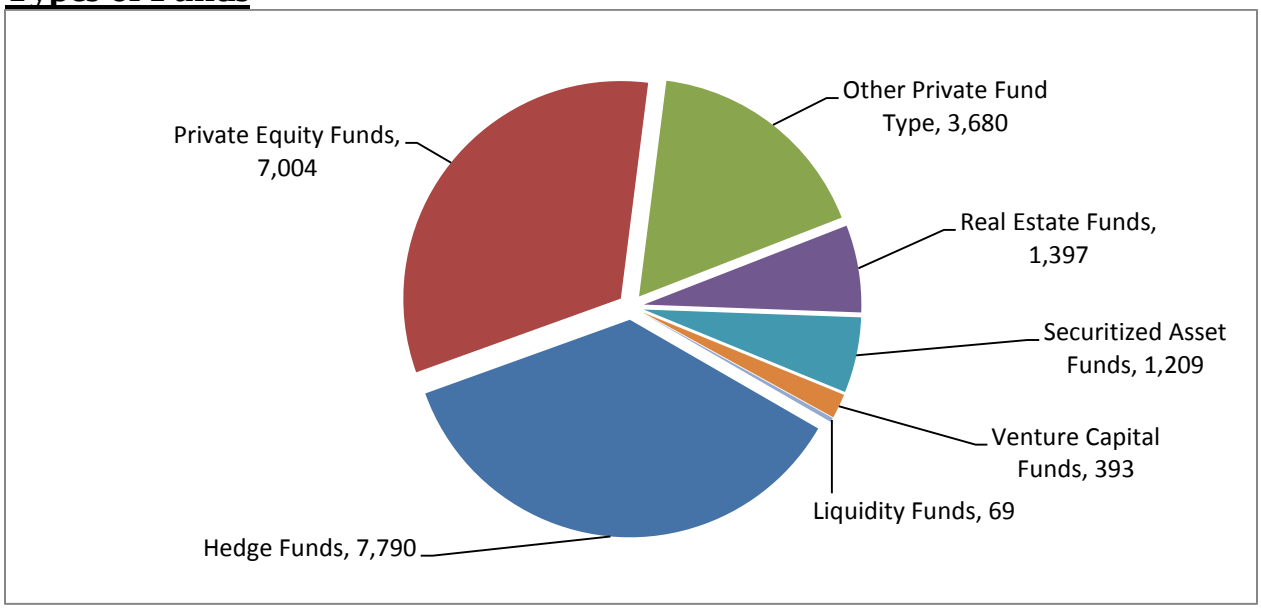
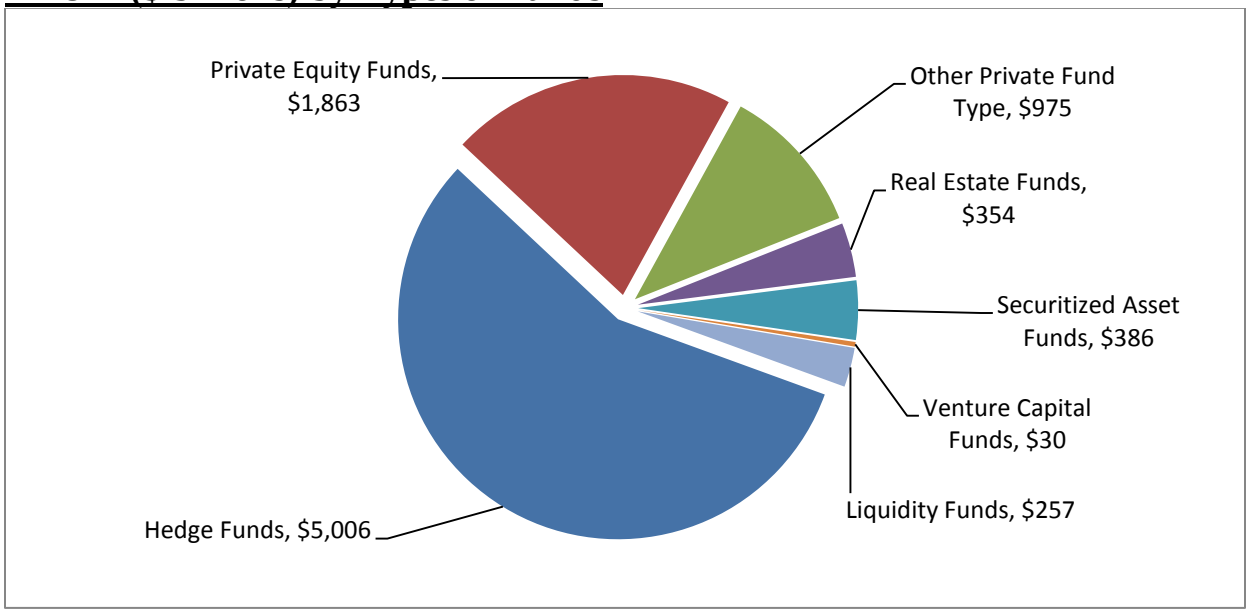
[1] Because of the definition of the categories, an adviser could be classified in two of these categories. For example, a large liquidity fund adviser could also be a large hedge fund adviser. The "total" number of advisers identified here does not double-count advisers that are classified in multiple categories. Therefore, the sum of the four categories results in a larger total than the total shown.

[2] The "total" number of private funds includes 2,561 additional private funds that are not included in this chart because, although they are private funds advised by a large adviser, they are not advised by the identified category of adviser. For example, the "total" does not include a hedge fund that is advised by a large private equity fund adviser.

## Types of Funds




## RAUM ($ billions) by Types of Funds



*Private Fund Regulatory Assets Under Management Reported by all Filers*

$8.871 trillion

*Parallel Managed Accounts[3] Reported by all Filers*

$2.46 trillion

*Qualifying Hedge Fund Population[4] Reported by all Filers*

1,326 Qualifying Hedge Funds reported by 460 filers.

*Qualifying Hedge Fund Regulatory Assets Under Management Reported by all Filers*

$4.046 trillion

*Liquidity Funds Following 2a-7 as Reported by Large Liquidity Fund Advisers*

27 (52%) liquidity funds advised by Large Liquidity Fund Advisers reported that they are managed in compliance with all of the risk limiting conditions of Rule 2a-7 of the Investment Company Act.

*Aggregate Gross Value of Controlled Portfolio Companies[5] as Reported by Large Private Equity Advisers*

$7.441 trillion

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[3] A Parallel Managed Account is any managed account advised by a filer that pursues substantially the same investment objective and strategy and invests side by side with a filer's private fund.

[4] A Qualifying Hedge Fund is a hedge fund with a net asset value of at least $500 million.

[5] A Controlled Portfolio Company is a portfolio company that is controlled by the private equity fund, either alone or together with the private equity fund's affiliates or other persons that are part of a club or consortium including the private equity fund.