Understanding and Navigating Current SEC Exam Deficiencies and Enforcement Trends: What Private Fund Advisers Need to Know

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Introduction and Roadmap

- CPE/CLE Credit Instructions
- Q&A Guidelines
- Panel Introductions
- Agenda
  - Industry Trends and New Enforcement Risks
  - Deficiency Letter Basics
  - Significant Exam Deficiencies

Industry Trends and New Enforcement Risks

"Retailization" of Private Funds

- Exemptive relief from Section 17(d) of the Investment Company Act
- August 2025 Investment Company Act guidance – 15% limit on private fund investments removed
- August 2025 executive order facilitating private assets in 401(k)s
- Spurring M&A activity

Artificial Intelligence - While Artificial Intelligence presents opportunities for advisers, compliance issues abound

- Books and records
- Privacy/cybersecurity
- Marketing
- Enforcement is watching

Crypto

- What is a "security"?
- Custody issues

Return of SPACs

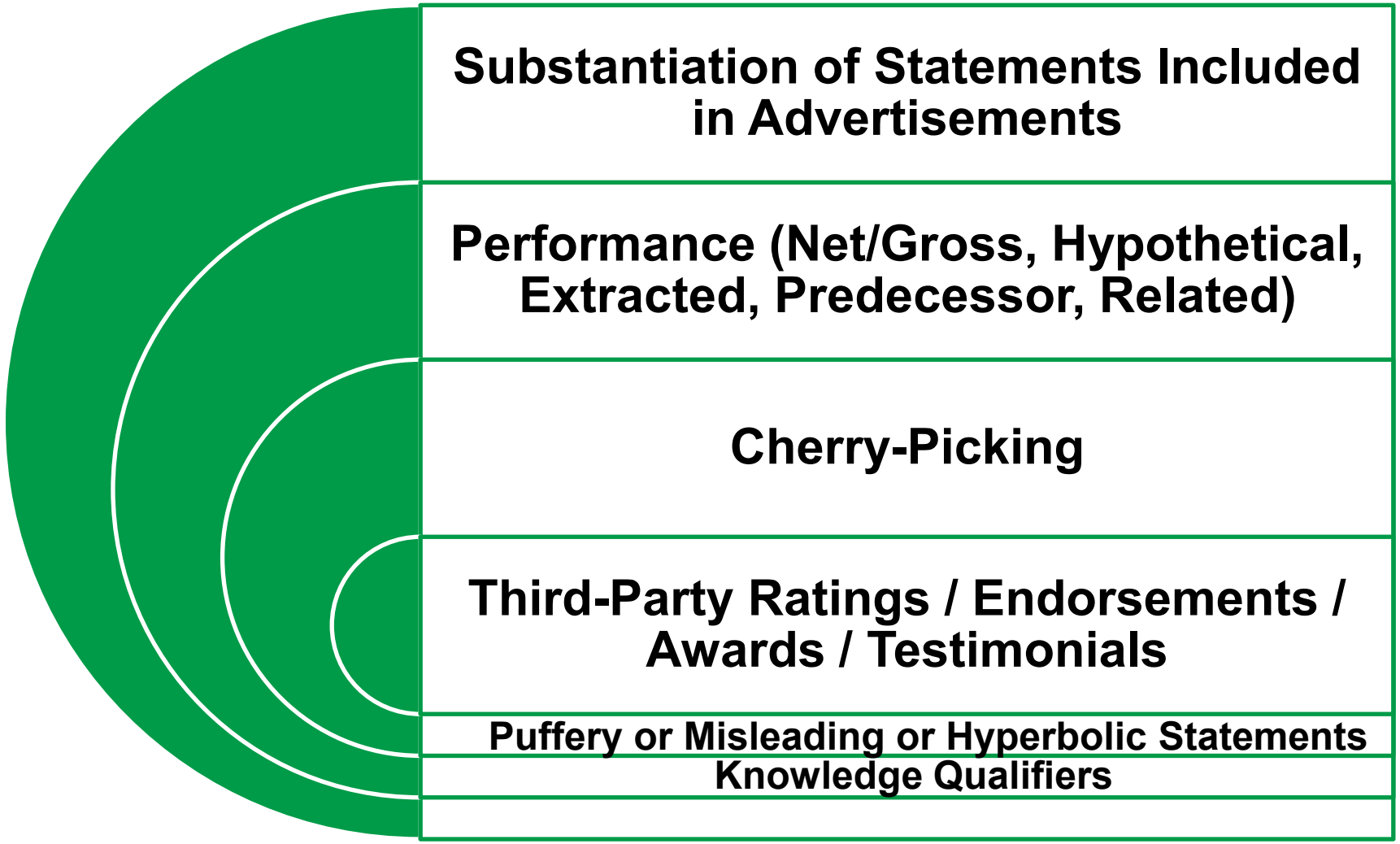
- Targeting crypto firms and registered funds
- How will SEC react?

Deficiency Letter Basics

- How often do advisers receive a deficiency letter?
- How should advisers interpret a deficiency letter upon receipt? Consider prospects of:
  - Future exam;
  - Referral to enforcement; and
  - Queries from current and prospective limited partners
- What are the pros and cons of various response options?
- New administration does not mean decreased exam activity or deficiencies, but potential priorities such as:
  - Accurate disclosure, with a sharp focus on AI
  - Returning dollars to investors

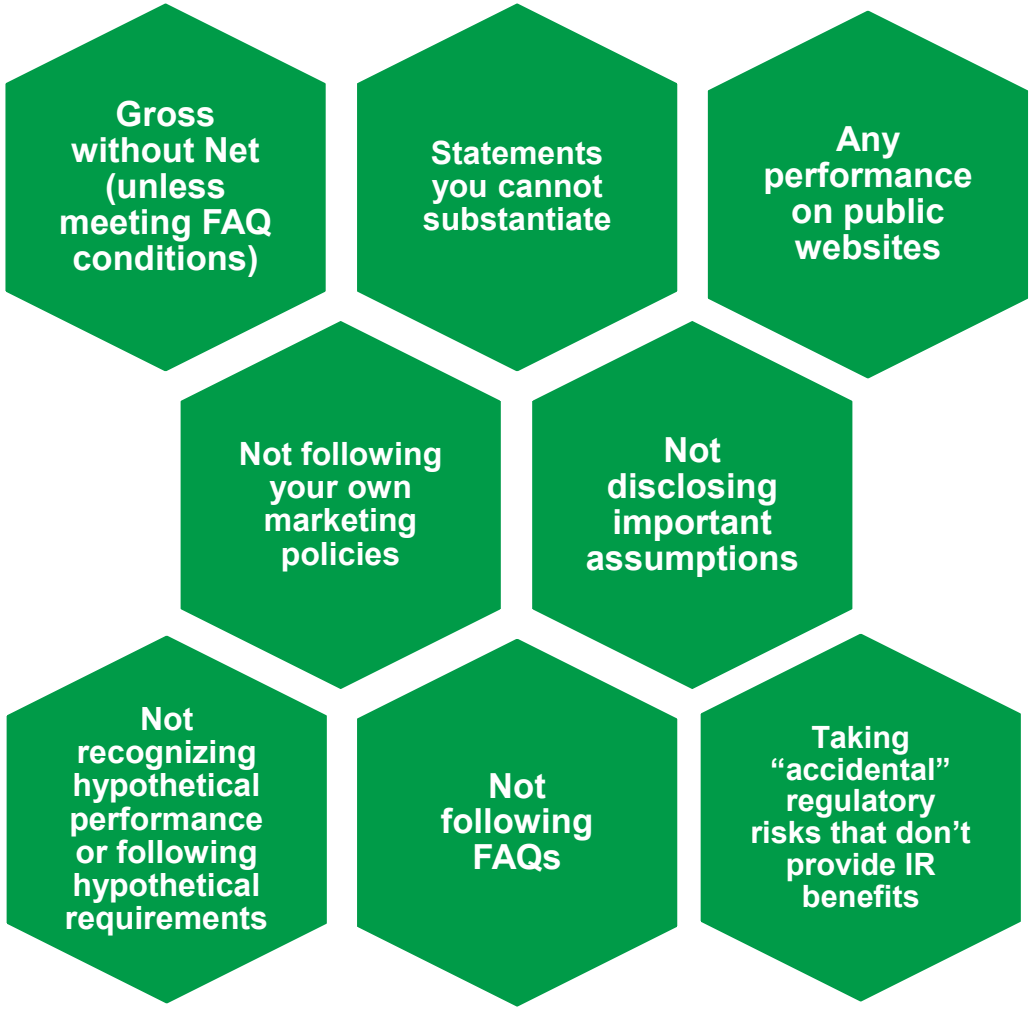
Significant Exam and Deficiency Topics and Possible Enforcement Interest

Exam Hotspots in Practice: Marketing



Exam Hotspots in Practice: Marketing continued

Marketing Rule "Do Nots"



September 2025 Enforcement Action

Adviser's website claimed it "refuse[d] all conflicts of interest", which contradicted Form ADV brochure disclosure of various conflicts of interest inherent in their role as an investment adviser. SEC found the adviser did not have a reasonable basis to believe that it would be able to substantiate the claim on its website that it refused all conflicts of interest.

Exam Hotspots in Practice: Marketing continued

How does the Marketing Rule impact an adviser's investments?

- The SEC is focused on all claims in marketing materials and has a particular sensitivity to AI in advertisements: disclosure and substantiation is paramount

How do we "substantiate"?

- Footnote or maintain substantiation file with backup/calculations for material facts

What are "material facts" / what needs to be substantiated?

- Numbers (even non-performance figures) should have a backup calculation
- Claims about AI and ESG (i.e., "portfolio company AI initiative led to $X in new revenue" → should be able to show data to support)
- Claims about market sizing, employee growth, number of customers, etc.
- Anything a reasonable investor would view as important in making an investment decision

Exam Hotspots in Practice: Marketing continued

In addition to ensuring proper substantiation, is there anything else to keep in mind when creating marketing materials?

Yes, there are a number of areas:

1. **Accuracy & Truthfulness:** Avoid puffery; ensure claims are accurate, substantiated and not misleading. Do not omit material facts
2. **Performance:** Include net performances (with and without facility) with gross performance and clearly disclose the methodology (unless FAQ conditions are met)
3. **Past Recommendations:**
   - Avoid "cherry-picking"; present balanced results with appropriate context
   - If including specific portfolio companies, ensure all are shown
4. **Testimonials/Endorsements/Awards:** Disclose the basis of claims, compensation, or conflicts of interest
5. **Hypothetical Performance/Projected Returns:**
   - Avoid guarantees; include disclaimers
   - Provide clear disclosures and assumptions
6. **Benchmarks:** Use appropriate benchmarks and disclose how they compare to the strategy
7. **Risk Disclosures:** Clearly explain all associated risks and rewards

Exam Hotspots in Practice: Fees and Expenses

Fees Paid to Affiliated Service Providers

The SEC is focused on advisers' disclosure with respect to fees paid by funds to affiliated service providers

"Market Rate" disclosure should be backed up by the adviser's written policies that are actually followed

"Duplicative services" Exam staff is focused on whether services provided are the same that are supposed to be provided by the adviser for the management fee.

Recycling

SEC is currently very focused on the practice of reinvesting realized proceeds into new investments, particularly with respect to performance and management fees

To the extent an adviser is not reducing "Invested Capital" for recycled amounts, this should be disclosed

Exam Hotspots in Practice: Fees and Expenses continued

Post-Commitment Period Management Fees

SEC will do a deep dive on calculation of Management Fee after the Commitment Period

<u>Considerations</u>: SEC expects to see robust disclosure around:

- **Capitalization of expense items and fees into "Invested Capital"**
- **Valuation policies, models and potential shortcomings**
- **Treatment of dividends and/or dividend recapitalizations: do they reduce "Invested Capital"?**
- **Expenses paid to affiliates: are these capitalized into "Invested Capital"?**
- **Treatment of write-downs, write-offs, partial realizations and dispositions**

Recent exam activity has shown that the SEC is willing to ask or encourage advisers to return millions in management fees to investors if they feel the calculation was not authorized in the LPA or sufficiently disclosed in the PPM

Exam Hotspots in Practice: Fees and Expenses continued

Management Fee Offsets

SEC will conduct a deep dive to ensure any "double dipping" is appropriately disclosed

Considerations: Where a Fund's management fee is only offset by that portion of fee income received by the Adviser that is actually allocated to the Fund (and not by amounts allocated to other vehicles invested in the portfolio investment), the SEC expects to see this arrangement transparently disclosed

August 2025 Offset Enforcement: Adviser failed to disclose that interest on deferred transaction fees from portfolio companies would not be included in management fee offsets. Adviser also failed to allocate transaction fees for a given portfolio company among advisory clients consistent with governing documents, resulting in overstated management fees.

Allocation of Fees and Expenses

The SEC has generally taken a "list-it or lose-it" approach to operating expenses in the LPA

Key to ensure that all expenses charged to the fund are authorized in the LPA

Exam Hotspots in Practice: Hedge Clauses

Hedge Clauses

- Advisers should ensure that their agreements do not misrepresent or contain misleading statements regarding the scope of the adviser's non-waivable fiduciary duty that could lead a client to believe that he/she has waived a non-waivable cause of action against the adviser
- Relevant even where an agreement contains a "savings clause" stating that compliance with state/federal securities law is not waivable
- SEC has recently brought enforcement actions against advisers for use of hedge clauses in advisory agreements and LPAs
- Recently, examiners have focused on industry-standard language in marketing materials disclaiming liability related to the accuracy or completeness of the information contained therein or claims that investors relied on alleged promises of future performance in such advertisements.

Examples

- **Example Hedge Clause in Marketing Materials**: "Certain information contained herein or in the memorandum has been obtained or is derived from sources prepared by third parties. While such information is believed to be reliable for the purposes used herein, none of the fund, the general partner, the manager or their respective affiliates (or any of their respective directors, officers, employees, members, partners, shareholders or agents) assumes any responsibility for the accuracy or completeness of such information. The fund has not investigated the accuracy or completeness of this information and has not independently verified the assumptions on which such information is based." .
- **Example Savings Clause**: "Notwithstanding anything to the contrary contained herein or in the Fund's governing documents, nothing contained herein or in the Fund's governing documents shall restrict, amend, eliminate or waive any fiduciary duties of an indemnified party (or any rights of the Funds or the investors in respect thereof) under (A) the Advisers Act or (B) any other applicable Federal or U.S. state law to the extent (but only to the extent) that such restriction, amendment, elimination or waiver would be in violation of such other Federal or U.S. state law."

Exam Hotspots in Practice: Operating Partners

- The SEC will consider adequacy of disclosure on compensation to operating partners and whether it is paid through the management fee or billed to portfolio companies
- Though operating partners may be retained as third-party consultants, advisers should ensure they are subject to robust compliance policies and procedures
- Operating partners must use the proper channels to preserve and maintain electronic communications
- Advisers should implement clear policies and procedures surrounding operating partners' access to systems, office space and meetings

Exam Hotspots in Practice: Custody Rule – Rule 206(4)-2

Is the Entity a Client?

- Question is obvious for primary funds, but becomes difficult as you move down the chain of ownership towards the underlying investment.
- At "some" point, the intervening entities cease being clients and become "the investment."
- There are factors to consider, but it is important to be consistent in your analysis.

Does the Adviser have Access to Client Assets?

- Being the general partner or managing member generally grants the adviser access.
- However, situations can become complicated when an adviser serves a sub-adviser or serves with a co-trustee.

Are the Assets Funds (Cash) or Securities?

- Can be a complicated question with real estate, loans and crypto assets.

Are there Other Issues?

- Outside Investors?

August 2025 Custody Enforcement: Where an adviser's president served as trustee and had signatory authority for advisory clients, the SEC found the adviser had custody of client funds through its related person and therefore required surprise examination.

Exam Hotspots in Practice: Conflicts Disclosures

Advisers should ensure that all conflicts of interest inherent in their businesses are fully and fairly disclosed in Form ADV governing documents or side letters, and that any requisite consent is obtained

- SEC will focus on:
  - use of debt (including fund-level credit lines);
  - investment allocations to preferred clients and co-investors;
  - adviser-led secondaries;
  - cross trades;
  - investments held by multiple funds; and
  - use of affiliated service providers in particular

- **Key Takeaway**: Be mindful anywhere that there's a conflict – Can it be cured with disclosure? Does it rise to the level of requiring consent (LPAC, investor etc.)?

Exam Hotspots in Practice: Borrowings

- To the extent interest expenses are capitalized into the management fee base, this practice needs to be disclosed in offering memoranda or governing documents.
- NAV credit facilities present unique risks which must be disclosed such as:
  - Foreclosure on fund investments as pledged collateral;
  - Violation of certain financial covenants where investment value decreases; and
  - Exposure of all fund assets to creditor claims where one asset suffers a loss.

Exam Hotspots in Practice: Material Nonpublic Information (MNPI) and Code of Ethics

Advisers Act Section 204A

- Requires all investment advisers, registered and unregistered, to establish, maintain, and enforce written policies and procedures reasonably designed to prevent misuse of MNPI by the adviser or any associated persons
- Advisers Act Rule 204A-1 requires all SEC registered investment advisers to adopt a code of ethics that sets forth, among other things, the standard(s) of business conduct expected from the adviser's "supervised persons"
  - Advisers' "access persons" are also required to report their personal securities transactions and holdings to the advisers' CCOs or other designated persons

August and September 2024 Enforcement Actions

- The SEC brought charges against investment advisers for failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI in its business activities
- **Key Takeaway**: General MNPI policies are not enough - advisers should ensure that their MNPI policies are specifically tailored to their business, such that all key aspects are appropriately addressed
  - This may carry special implications for credit funds and CLO advisers

Exam Hotspots in Practice: Artificial Intelligence ("AI") Adoption

- Initial enforcement activity by the SEC under the current administration indicates ensuring accurate disclosure on AI will be a key objective.
- Special attention to disclosures in all marketing materials related to AI, including those on websites and in social media, should be accorded as false or misleading statements therein may be the source of 10(b) charges.
- Advisers should also carefully consider the role of AI with respect to maintaining books and records as well as privacy and cybersecurity controls
  - *April 2025 Enforcement Actions:*
    - *Saniger:* The SEC brought charges against the founder of the "Nate" app which purported to allow users to purchase items from any e-commerce site clicking "buy". However, marketing materials falsely advertised that the remainder of the checkout process would be completely handled by AI.
    - *Palafox:* PGI was advertised as a crypto asset and foreign exchange company, and investors were told that PGI had developed a platform to trade crypto assets using AI. The SEC brought charges alleging little to no trades were being conducted on investors' behalf, through AI or otherwise.

Exam Hotspots in Practice: Whistleblowers

- **Whistleblower Carveouts (21F-17)**
  - No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement with respect to such communications
  - SEC votes in favor of these matters regularly, often 5-0 during the last Commission
  - Appropriate carveouts should be included in the following agreements:
    - limited partnership agreements;
    - employment-related agreements (e.g., separation agreements, confidentiality agreements);
    - settlement agreements;
    - third party provider / consulting agreements;
    - confidentiality agreements/NDAs;
    - policies and training materials; and
    - client, customer, and investor agreements.