

Top 10 Compliance Concerns for Private Fund Managers

As fund managers, many of your worries arise from your particular agreements. Side letters with numerous limited partners (LPs) across dozens of funds become a web of obligations. Adhering to those responsibilities is imperative to mitigate your litigation and reputational risk.

However, your contractual obligations are far from your only concern. Historically, private equity enjoyed a lighter regulatory burden. Yet, in recent years, the SEC has noticed private equity's growth — assets under management reached \$18 trillion in 2021¹ — and its potential impact on retail investors. That awareness intensified enforcement efforts and proposed reforms.

The best tactic to improve compliance on every front is to face your biggest risks head on. Here's an overview of significant compliance concerns within the private equity space, including a brief look into the future.

1. SIDE LETTERS

Though side letter adherence is an obvious concern, you can't overstate its importance. Given the nature of side letters as a means of negotiating terms outside of the funds' governing agreements, these documents inherently complicate your compliance efforts. The true challenge is respecting multiple side letters per fund across multiple funds. Yet tracking your obligations manually is an excessive burden. In light of the SEC's proposed private equity reforms, it's time to review whether you could strengthen your compliance program with legal technology². You'll want to be prepared if regulatory changes impact common side letter practices and disclosures.

2. INVESTMENT RESTRICTIONS

Within side letters, LPs tend to request investment restrictions, including capital concentration limits related to specific products, services, industries, and even geographic regions. LPs may base these requests on regulatory concerns, tax requirements, environmental, social, and governance (ESG) factors,


and more. Whatever the underlying intent, your fund can't run afoul of these restrictions. To that end, it helps to be able to quickly review and analyze myriad restrictions as you adjust your investments. Contract intelligence technology can provide that visibility.

3. REPORTING REQUIREMENTS

Another complexity arising from side letters is inconsistent reporting requirements. In addition to customary reports driven by the Limited Partnership Agreement, many investors are demanding more information. Depending on how you negotiate these terms, your reporting requirements and deadlines may vary from one LP to the next, increasing your team's workload and potentially leading to instances of noncompliance.

4. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE

Right now, there is no unified guidance for ESG requirements. The best information the private



equity industry has is the United Nations-supported Principles of Responsible Investment³. The effect of the lack of clear requirements is that you end up juggling various ESG philosophies between yourselves and your LPs. What matters most is you deliver on what you promise — whatever that may be — the same as you do with investment restrictions, bespoke reporting requirements, and other side letter provisions.

5. DATA SECURITY

Data privacy and cyberthreats are significant growing concerns within the financial services industry. From ransomware to phishing schemes, you can safely assume that threats will only increase. In response, you'll want to take steps to review your portfolio risk analysis procedures and cybersecurity measures. This approach isn't for your benefit alone. Many LPs also want to know your cybersecurity procedures for preventing and responding to attacks and will insist that you have industry standard protections in place. You'll also have to keep up with evolving data privacy laws that vary by jurisdiction, such as the General Data Protection Regulation, California's Consumer Privacy Act and Privacy Rights Act, the Virginia Consumer Data Privacy Act, and the Colorado Privacy Act.

6. FEES AND EXPENSES

The SEC is keeping a close watch on advisers' fees and billing practices. Mid-2020, the Office of Compliance Inspections and Examinations (OCIE) reported observing fees and expenses inconsistent with disclosures to LPs, expenses over contractual limits, and violations of GPs' expense policies⁴. The SEC's concern is significant enough that they have proposed regulations that would increase transparency around private fund managers' fees. If passed, the rules would require you to issue a quarterly statement to investors, accounting for all fees and expenses the private fund paid during the reporting period, as well as any other amounts paid to the adviser or other persons⁵.

7. VALUATION POLICIES

OCIE also identified instances of private asset valuations inconsistent with advisers' valuation processes or disclosures to LPs. The SEC recognizes the challenges and judgments required in valuing

these assets; however, it's most interested in protecting against manipulation that increases investors' fees or harms their returns. To avoid SEC scrutiny, you must adhere to your funds' valuation policies and disclosures when calculating and adjusting net asset values.

8. FIDUCIARY DUTIES

The Investment Advisers Act creates a fiduciary duty for SEC-registered investment advisers at the federal level, which LPs can't waive⁶. Yet, a 2020 Institutional Limited Partners Association (ILPA) survey found 71% of LPs had contractually modified or eliminated fiduciary duties in at least half their private equity funds in the previous 12 months⁷. The ILPA and SEC are equally concerned with the number of fiduciary duty waivers that may be inconsistent with the Investment Advisers Act. It's best to proceed with caution with regard to these waivers.

9. CONFLICTS OF INTEREST

The OCIE observed several deficiencies in how advisers handle potential conflicts of interest. Many of these issues hinged on advisers failing to adequately disclose to LPs their allocation of investments among clients, economic relationships with other investors or clients, preferential liquidity rights, and co-investments, just to name a few. The SEC's concern is significant enough to influence its proposed private equity reforms, which include the requirement to obtain a fairness opinion regarding adviser-led secondary transactions and prohibitions on several adviser activities⁸.

10. MATERIAL NONPUBLIC INFORMATION (MNPI)

It's imperative to thoroughly address risks associated with MNPI gained under nondisclosure agreements, through board membership, and from other circumstances. The OCIE observed several issues, including advisers failing to establish, maintain, and enforce written internal policies regarding MNPI. It's critical to minimize any appearance your firm made decisions based on MNPI. The SEC may take action against you even if the circumstances don't give rise to insider trading charges. Having a system in place to guard against improper use of MNPI is critical to the success of your business.

Improve compliance with technology

Your compliance efforts often hinge on accurately tracking your obligations across all your funds. In the past, that required time-consuming manual work. However, human-in-the-loop technology offers a respite from reviewing hard copies of fund documentation, confirming compliance with the terms of multiple side letters, and handling confidentiality agreements. Learn how **Insight from Ontra** can transform your compliance with fund obligations and strengthen your investor relationships.



About Ontra

Ontra is the global leader in Contract Automation and Intelligence for private asset management firms. The Ontra platform combines AI-enabled software with a worldwide network of highly trained lawyers to modernize recurring legal workflows. Ontra's solutions improve all aspects of the contract lifecycle — from negotiating and processing routine contracts to tracking obligations in complex agreements. Ultimately, Ontra reduces the time, expense, and risk associated with contract management, freeing its customers to focus on other strategic priorities.

Ontra is headquartered in San Francisco, with global operations across North America, Europe, and Asia. Learn more at www.ontra.ai.

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¹ <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2021-q2.pdf>

² <https://www.sec.gov/news/press-release/2022-19>

³ <https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment>

⁴ https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf

⁵ <https://www.sec.gov/rules/proposed/2022/ia-5955.pdf>

⁶ https://www.sec.gov/news/speech/gensler-ilpa-2021110#_ftn1

⁷ https://ilpa.org/wp-content/uploads/2020/06/2020-ILPA-Fund-Terms-Survey-Highlights_External.pdf

⁸ <https://www.sec.gov/files/ia-5955-fact-sheet.pdf>