

# The Top 10 Compliance Concerns for Private Fund Managers

As fund managers, many of your worries arise from your particular agreements. Side letters with numerous 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 — private markets AUM reached \$11.7 trillion as of June 30, 2022 — and its potential impact on retail investors.<sup>1</sup> That awareness intensified enforcement efforts in recent years.

Leading private firms are relying on Insight, Ontra's AI-powered private fund lifecycle software, to confidently manage their investor obligations and prepare for SEC scrutiny.

Here's an overview of significant compliance concerns within the private equity space.

## 01

Side Letters

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Investment Restrictions

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Reporting Requirements

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ESG

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Data Security

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Fiduciary Duties

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## 01 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 intense scrutiny, it's time to review whether you could strengthen your side letter compliance program with legal technology.

“[The objective] at the top of the list was being able to confidently and quickly provide that list of side letter provisions to the SEC when asked for it. And that was exactly what Insight did.”



**Kimberly Futrell**

CCO & CFO, Pharos Capital Group

## 02 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. A purpose-built private fund lifecycle solution can provide that visibility.

## 03 Reporting Requirements

Another complexity arising from side letters and SEC regulations is mounting reporting requirements. In addition to customary reports driven by limited partnership agreements (LPAs), many investors demand more information. You also have SEC reporting requirements, such as Form PF, Form ADV, and Schedules 13D & G. Varied reporting requirements increase your team's workload, potentially leading to errors and instances of noncompliance.

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## 04 ESG

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Right now, there is no unified guidance for ESG requirements. As GPs in the U.S. navigate various LP requests, the best information they have is from the UN-supported Principles of Responsible Investment.<sup>3</sup> For GPs operating in more than one country, the situation is even more complex. They are contending with various requests from LPs in addition to different regulatory frameworks.<sup>4</sup> While you must adapt to global regulatory differences, what matters most across jurisdictions is that you deliver what you promise — whatever that may be — the same as you do with investment restrictions, bespoke reporting requirements, and other side letter provisions.

## 05 Data Security

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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 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, and other U.S. state data privacy laws and regulations.

## 06 Fees and Expenses

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The SEC continues to keep 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 policies.<sup>5</sup>

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

<sup>4</sup> [https://marketingstoragerags.blob.core.windows.net/webfiles/ESG\\_Global\\_Survey\\_of\\_ESG\\_Regulations.pdf](https://marketingstoragerags.blob.core.windows.net/webfiles/ESG_Global_Survey_of_ESG_Regulations.pdf)

<sup>5</sup> [https://www.sec.gov/files/Private%20Fund%20Risk%20Alert\\_0.pdf](https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf)



## 07 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.

## 08 Fiduciary Duties

The Investment Advisers Act creates a fiduciary duty for SEC-registered investment advisers at the federal level, which LPs can't waive.<sup>7</sup> Yet, a 2020 Institutional Limited Partners Association (ILPA) survey found 71% of LPs had contractually modified or eliminated fiduciary duties in at least half of their PE funds in the previous 12 months.<sup>8</sup> 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.

**“I don't think we could have been as effective in our response to the SEC without these obligations documented in Insight.”**

**New York-Based Private Equity Firm**

<sup>7</sup> [https://www.sec.gov/news/speech/gensler-ilpa-20211110#\\_ftn1](https://www.sec.gov/news/speech/gensler-ilpa-20211110#_ftn1)

<sup>8</sup> [https://ilpa.org/wp-content/uploads/2020/06/2020-ILPA-Fund-Terms-Survey-Highlights\\_External.pdf](https://ilpa.org/wp-content/uploads/2020/06/2020-ILPA-Fund-Terms-Survey-Highlights_External.pdf)

## 09 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.

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## 10 Material Nonpublic Information

It's imperative to thoroughly address risks associated with Material Nonpublic Information (MNPI) gained under NDAs, 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 the risk of making 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.

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### ABOUT ONTRA

Ontra is the global leader in AI-powered legal technology solutions for private capital investment firms. Ontra's Legal Operating System combines innovative, purpose-built software with a global network of highly trained professionals to digitize recurring legal workflows across the full fund lifecycle and comprises Contract Automation, Insight, and Ontra Atlas. Ontra works with the world's leading investment banks, private equity and venture capital firms, direct lenders, law firms, and service providers to reduce the time, expense, and risk associated with contract and fund management.

To learn more about Ontra's solutions, visit [ontra.ai](https://ontra.ai) or call 1-888-611-4415.