Regulatory and Enforcement

Schulte Roth & Zabel

PRIVATE EQUITY FUND CONFERENCE

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Stephanie is co-head of SRZ's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (LBO, mezzanine, distressed, real estate, venture) and liquid-securities funds (hedge funds, hybrid funds), as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses, and she represents funds of funds and other institutional investors in connection with their investment activities.

Recently named chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a member of the board of directors of 100 Women in Hedge Funds, a member of the Board of Visitors of Columbia Law School and a member of the board of directors of the Girl Scouts of Greater New York. She is listed in *Chambers USA*, *Chambers Global*, *IFLR1000*, *The Legal 500 United States*, *Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which ranked her at the top of the world's 2014 "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Expert Guide to the World's Leading Women in Business Law* and *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the 2014 Who's Who Legal Awards and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute) and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private Equity Handbook 2005/06* (Practical Law Company) and a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

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Brad focuses his practice on counseling hedge funds and private equity funds on operational, regulatory and compliance matters. He represents clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the United Kingdom with respect to regulatory, compliance, trading and operations. Prior to joining SRZ, he served for 12 years in various in-house roles, including as general counsel and chief compliance officer of investment advisers ranging from multibillion-dollar funds to start-ups, and as a member in the asset management group of a leading investment bank.

A frequent speaker and writer on the topics of fund operations and regulatory compliance, Brad most recently presented on SEC examination priorities for hedge funds; FinCEN's new proposed anti-money laundering rule; market terms and regulatory issues for co-investments; regulatory changes to Form ADV and recordkeeping requirements; and other compliance topics for private investment funds. He also contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-authored "The New AML Rules: Implications for Private Fund Managers" and "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation," which were published in *The Hedge Fund Journal*.

Brad received his J.D., *cum laude*, from Boston College Law School and his B.A., *magna cum laude*, from Georgetown University.

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Charles represents financial institutions, public companies and accounting firms, and their senior executives, in securities-related enforcement proceedings before the SEC, DOJ, FINRA, PCAOB, and other federal and state law enforcement and regulatory authorities. In particular, he counsels hedge funds, private equity firms, venture capital funds and other asset managers through regulatory scrutiny, including in routine and risk-based inspections and examinations and in enforcement proceedings. He defends investigations involving a broad spectrum of issues, including accounting and disclosure fraud, insider trading, foreign corruption, offering fraud, market manipulation, breach of fiduciary duty and conflicts of interest. In addition, Charles represents boards of directors and associated committees in internal investigations, and he provides guidance on corporate governance and trading practices for public companies and private funds. Prior to entering private practice, Charles served for nine years in the SEC's Division of Enforcement, most recently as assistant director supervising the investigation and prosecution of some of the SEC's most significant matters, including its investigation of Enron Corporation.

A frequent speaker and panelist, Charles has addressed a wide variety of topics of interest to the white collar defense community, including, most recently, examination priorities and enforcement risk for hedge funds, the Wells settlement process at the SEC, and short-selling violations under Rule 105. He recently co-authored "Rule 105 Update: New Round of Enforcement Highlights SEC Approach on Short-Selling Violations" in *The Hedge Fund Journal*, and he wrote the "Use of Paid Consultants" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). Charles also serves as a resource for numerous media publications, including *Bloomberg News*, *The Wall Street Journal* and *The Washington Post.*

Charles holds a J.D. from the New York University School of Law and a B.A., with high distinction, from the University of Virginia.

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Regulatory and Enforcement

I. SEC Exams Update

A. Inter-relation Between Exams and Enforcement

1. The examination staff and the enforcement division are converging. In addition to inviting enforcement into the exam process or referring deficiencies to enforcement for more investigation, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") itself has adopted investigative tools and potential sanctions that usually were reserved for enforcement.

2. For example, OCIE has begun to require funds to provide affirmative narratives as to why certain conduct is not a violation, similar to a mini-Wells submission during the exam process. These narratives are forcing firms to accept an affirmative burden to disprove a negative.

3. In terms of corrective measures, OCIE has begun imposing more significant sanctions formulated as voluntary remedial steps. These enforcement-like corrective measures include disgorgement and reimbursement of fees and expenses, hiring of third-party compliance consultants and monitors, drafting new policies and procedures, and implementing new systems to safeguard against potential compliance violations.

B. Enhanced Examination Capabilities

1. OCIE has adopted tools and hired personnel that allow OCIE to more efficiently uncover violations of the Advisers Act during exams.

2. OCIE has hired new personnel over the past several years that have significant private sector experience working in the private funds industry. OCIE has hired experts with industry experience in particular areas including in private equity, cybersecurity, pricing, valuation and audits.

3. Note that the director of OCIE and the head of OCIE's private funds unit are industry experts, formerly with hedge funds and private equity funds.

4. As a result, OCIE is now more familiar with the industry and is in a better position to understand the operations of most private equity fund managers, investments and risks.

C. Different Types of Exams

1. Full/comprehensive exam. SEC request list with 60+ requests (all investments, fund documents, marketing materials, custody, valuation, expenses, co-investments, side letters).

2. Never-before-examined initiative.

3. Focused exams. SEC focusing on particular issues (fees and expenses, valuation, co-investments).

4. Recidivist exams. SEC specifically mentioned as a priority for 2016, that if an adviser has been examined and had significant deficiencies, the adviser should expect the SEC to be back within a year or two.

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D. Length of an SEC Exam

1. All depends on the adviser and the strength of the adviser's compliance program.

2. If the adviser is prepared and demonstrates that it has a strong compliance infrastructure, exams could last only a week or two with a few additional requests, resulting in either a few deficiencies or a clean bill of health (most firms receive some deficiencies).

3. If the SEC finds serious weaknesses in the adviser's compliance program, exams can last much longer (months to a year), with many additional requests, resulting in serious deficiencies, monetary penalties to the adviser and risk of enforcement.

II. Common Examination Focus Areas for Private Equity

A. Fees and Expenses

1. OCIE is focused on fees and expenses in examinations of private equity sponsors.

2. SEC staff have recently confirmed what we've been seeing in exams of PE managers, which is that the exam staff believes there to be significant compliance issues to address, particularly in connection with fees and expenses. After examining more than 150 private equity fund managers, the exam staff reported that when they reviewed fees and expenses, they found more than 50 percent of managers to have violated the law or to have material internal control weaknesses. The former head of the exam staff called this a "remarkable statistic" and the message is clear: if you haven't yet been examined, you should be reviewing these matters to make sure you are in compliance.

3. The SEC's list of examination priorities for 2016 reflects that this will be a continued area of focus for exams of all private equity fund managers. Common deficiencies that relate to expense allocation include:

    (a) Over-allocation of expenses to one investor, as opposed to other investors;

    (b) Improperly allocating "mixed use" expenses between the manager and its investors; and

    (c) Charging to investors expenses that are not adequately disclosed to investors.

4. Disclosure

    (a) In examination, OCIE exam staff are auditing fee and expense disclosures very closely. The SEC's expectations in terms of the specificity of disclosures has changed from two years, one year or even six months ago. The SEC expects clear and specific disclosures with respect to fees and expenses being charged to investors.

    (b) Advisers should be mapping fees and expenses billed to investors to specific disclosures included in fund PPMs, LPAs and LLCAs, and Form ADV.

5. Fee and Expense Focus Areas for Private Equity

    (a) Fees

        (i) Fees paid to joint venture partners;

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(ii) Transaction fees and whether these fees reduce management fees;

(iii) Monitoring fees, including accelerated monitoring fees; and

(iv) Consulting, advisory and director fees.

(b) Expenses

(i) Reasonableness, rationale and records of expense allocation methodologies. Very important to be able to back up expense allocation rationale to show it is reasonable and to keep contemporaneous records showing how the adviser made the allocation decision and why.

(ii) Expenses at the fund level versus portfolio company level. OCIE staff will review expenses allocated by the adviser at both the fund level and expenses billed by the adviser directly to the portfolio company.

(iii) Overhead expenses. Any billing of adviser overhead expenses to investors will be closely scrutinized.

(iv) Marketing expenses versus investment expenses. OCIE staff will scrutinize travel expenses, conferences, specific systems, etc., to determine whether they are for investment purposes or marketing purposes.

(v) Co-investments. Focus on how dead deal costs are being allocated across funds and co-investors. Will depend on whether co-invest capital is committed or not. Many new private equity funds are adding disclosures.

(vi) Proprietary investments. Focus on whether expenses are being allocated fairly to proprietary investments or whether those proprietary accounts are getting a "free ride."

B. Co-Investments

1. Allocation. PE managers are considering additional disclosures on co-investments in terms of who gets co-investments and expense allocation between funds and co-investors.

2. If the fund has concrete guidelines/caps on investing only a certain percentage in any one deal, then it is more objective and straightforward to justify allocations to the fund versus co-investment vehicles. If there are no hard guidelines, it is more subjective and advisers need to be prepared to justify why the fund was allocated X and co-investors were allocated Y.

3. It is very important that disclosures be consistent across PPMs, LLCAs or LPAs, Form ADV — and side letters, RFPs, DDQs and marketing materials.

4. Dead deal costs continue to be a focus area in SEC exams. Many new private equity funds are adding clarifying disclosures if a fund is paying for all dead deal expenses.

C. Valuation

1. OCIE often focuses its examinations on valuation processes and, in particular, on any gaps between the valuation procedures as disclosed to investors and as carried out in practice.

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2. OCIE has focused on situations where managers have changed their valuation methodologies and have either:

   (a) Not properly disclosed the change in the valuation methodologies to investors; or

   (b) Failed to effectively adhere to the disclosed valuation methodology.

3. OCIE will examine closely quarterly valuation committee meeting materials and when an adviser has committed to have quarterly meetings, the Staff will expect that the adviser is keeping minutes/notes for those meetings and a record of what was discussed and decided.

4. Other Valuation Issues

   (a) Role of independent valuation experts;

   (b) Effect of sale of minority positions;

   (c) Backup for marks on unrealized investments;

   (d) Inflated reported returns due to non-consideration of fee discounts, waivers and fees outside commitments; and

   (e) Performance attribution to split teams — who has track record after split.

D. Marketing

1. Marketing materials. Marketing materials have long been an area of focus during exams. In an exam, the SEC will request your pitch books, DDQs, versions of your website and any other "advertisements," including materials included on investor portals. The SEC will closely scrutinize these materials to make sure these materials are overall fair and balanced, comply with the specific SEC advertising rules, and are all consistent.

2. Cherry-picking. Often private equity managers would like to highlight the performance of particular investments or portfolio companies, perhaps in case studies. The general rule is that selected case studies that do not include performance data are acceptable if they are chosen on an objective non-performance basis, but if you are providing performance information for some investments, you should provide the same information for all investments (even if you are not necessarily providing case studies for all investments).

3. Net IRRs vs. Gross IRRs. The SEC always wants to see net IRRs. Gross IRRs are acceptable alongside net IRR data shown with equal prominence. There may be instances where it may difficult to prepare net IRRs (e.g., for proprietary capital investments or in situations where the fund pays out carried interest only after return of all contributed capital). This should not, however, mean that fund-wide net IRRs should not be disclosed, as these can be calculated using exit prices and/or current portfolio company valuations. Net IRRs can also be calculated for unrealized investments (with the appropriate footnotes that make it clear that the net IRR calculation assumes that unrealized investments have been sold at their most recent fair value).

4. Projections. The SEC has consistently highlighted projections and hypothetical performance as focus areas. If a private equity fund manager is going to show projections, the adviser must make it clear these are projections — not actual performance. An adviser should be able to back up any

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projections to show that the assumptions are reasonable. Also, FINRA rules are even more restrictive here and prohibit showing projections.

E. Custody

1. The SEC has continued to focus on compliance by advisers with the Custody Rule (Rule 206(4)-2).

2. Registered investment advisers are generally required to maintain client funds and securities to which they have access with a "qualified custodian" (such as a bank) in segregated client accounts. There is an exception to this requirement in the case of "privately offered securities" held by a client that is a "pooled investment vehicle" (such as a typical PE fund). To qualify under this exception, among other things, the pooled investment vehicle must comply with the Pooled Vehicle Annual Audit Exception such that: (a) the fund is subject to an annual audit by an independent public accountant registered with the Public Company Accounting Oversight Board; and (b) its audited financials must be prepared in accordance with US GAAP and delivered to investors within 120 days after the vehicle's fiscal year-end.

3. Under Rule 206(4)-2, "privately offered securities" must be acquired in transactions not involving a public offering, must be uncertificated (such that ownership is only recorded on the books of the issuer) and the transfer must be subject to the consent of the issuer or other investors. The SEC staff clarified in a Guidance Update that partnership agreements, subscription agreements and LLC agreements are not "certificates" for purposes of the custody rule. The SEC staff also indicated that even if a security is certificated, it can be held by the adviser itself if: (a) the fund is complying with the Pooled Vehicle Annual Audit Exception; and (b) the stock certificate is issued in the name of the vehicle is appropriately legended, and can be replaced upon loss or destruction.

4. Some managers were unclear as to the treatment of special purpose vehicles ("SPVs") (such as alternative investment vehicles and pooling vehicles used in connection with co-investments) that are often interposed between a fund complex and its underlying portfolio investments for tax, regulatory or similar reasons. As to the use of SPVs, the SEC staff clarified that whether the vehicle is used for one or more underlying investments, so long as it is exclusively owned by one or more pooled investment vehicle clients of the registered adviser, and/or the adviser itself and/or its related persons, and the assets of the special purpose vehicle are considered within the scope of the pooled investment vehicle's financial statement audit, the SPV need not be separately audited as an individual client. If, however, the SPV is an "investment advisory client," which will depend on the facts and circumstances, and the SPV is used to acquire an investment not exclusively on behalf of pooled investment vehicle client(s), but also on behalf of one or more third parties that are not clients of the adviser, then the SPV itself may need to be treated as a separate client, and may require a separate audit.

5. As to the use of escrows in M&A transactions, the SEC indicated that it will not object if, in the aftermath of a negotiated M&A transaction, an adviser maintains client funds in an escrow with other client and non-client assets, provided that the client is a pooled investment vehicle that relies on the Pooled Vehicle Annual Audit Exception, and includes the portion of the escrow attributable to the pooled investment vehicle in its financial statements, and, among other things, a designated seller's representative is required to make prompt distributions upon resolution of the escrow.

F. Insider Trading

1. As in prior years, OCIE often closely scrutinizes relationships between the investment adviser and any outside consultants or expert networks. In addition, OCIE has focused on relationships between

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different buy-side firms, as well as information sharing with investors and the receipt of confidential information at certain industry conferences.

2. Examination staff have taken the position in many recent examinations that advisers should keep logs of meetings with company management.

G. Secondary Transactions

1. Potential conflicts regarding fees. The issue is the amount charged to secondary buyers and whether any preference is given to fee-paying buyers.

2. Potential conflicts regarding valuations. The issue is whether low valuations and limited access to information force sales to the sponsor and friends of the sponsor.

3. Asset sale vs. tender. Need to consider issues raised by active sponsor involvement in the process.

H. Advisory Committee Conflicts

Need to consider potential conflicts or appearance of conflict between large investors on the adviser committee and small investors.

I. Compliance Program

1. OCIE frequently scrutinizes the compliance program an investment adviser employs, including whether adequate resources are dedicated to the compliance function and whether the firm has a "culture of compliance."

2. Deficiency letters have identified perceived deficiencies in the knowledge and qualifications of chief compliance officers ("CCOs") in some cases.

J. Internal/Operational Controls

1. Registered advisers (and unregistered advisers, including Exempt Reporting Advisers). The SEC is focused on operational controls and is bringing enforcement actions where there is a breakdown of those controls.

2. Private equity fund managers should conduct a risk analysis of their internal/operational controls, including with respect to the following areas: fund and portfolio company accounts, wire authorizations, and verification of payees and wires. Any weaknesses discovered need to be addressed and internal procedures/safeguards strengthened.

3. Private equity fund managers should review internal procedures, and all expenses, accounts and wires should run through the CFO, rather than separate processes for corporate expenses versus expenses billed to portfolio companies.

III. Enforcement Update — New Focus on Internal Controls

A. The SEC pursued enforcement actions against several noteworthy private equity firms based on various types of violations, but one type of violation appeared repeatedly, regardless of the specific facts: failure to adopt and implement adequate policies and procedures.

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B. On May 12, 2016, Andrew Ceresney, Director of the Securities and Exchange Commission's Division of Enforcement, gave a speech in which he emphasized the SEC's focus on private equity firms (Andrew Ceresney, Director Division of Enforcement, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (May 12, 2016)). Earlier this year, Director Ceresney emphasized that the SEC has brought charges for pure internal controls violations, or in other words, pursued enforcement actions against entities that failed to maintain adequate controls and procedures, even absent underlying fraud charges. While this speech was in the context of public company reporting, a similar sentiment applies to the SEC's scrutiny of private equity fund managers (Andrew Ceresney, Director Division of Enforcement, Directors Forum 2016 Keynote Address (Jan. 25, 2016)).

C. Specific Enforcement Actions

1. *SEC v. Caspersen and Irving Place III SPV, LLC*, 1:16-cv-02249 (S.D.N.Y. Mar. 28, 2016); *United States v. Caspersen* (S.D.N.Y. Mar. 28, 2016)

(a) The SEC and DOJ recently charged an individual in parallel civil and criminal proceedings with allegedly using false and misleading statements to solicit and secure large investments from institutional investors under the illusion that the investments would be secured by assets of a private equity fund, Irving Place Capital Partners III SPV. In fact, the promissory notes are alleged to have been issued by a shell company, operating under an almost identical name as the legitimate private equity fund (Irving Place III SPV LLC) and controlled by the Defendant. As alleged by the SEC, when the Defendant received a $25 million investment, he took control of the funds for his personal use. The SEC charged Caspersen with violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The DOJ charged Caspersen with the same violations as well as a violation of 18 U.S.C. §§ 1343 and 2 (wire fraud).

(b) Caspersen is alleged to have falsely represented that he had authority from his employer, Park Hill Group (a firm that provides alternative asset advisory and fundraising services for private equity firms and hedge funds), to conduct deals on behalf of Park Hill Group with another private equity fund. Park Hill Group fired Caspersen the week before the government's complaints were filed.

2. *In the Matter of Fenway Partners, LLC, et al.* (Nov. 3, 2015)

(a) The SEC alleged that Fenway Partners LLC ("Fenway") and four of its executives failed to disclose conflicts of interest when fund and portfolio assets were used for payments to former firm employees and an affiliated entity. Fenway and the four involved executives are alleged to have caused certain portfolio companies to terminate their payment obligations under their existing Management Services Agreements and replaced those payment obligations with payment obligations under new Consulting Agreements with an entity affiliated with Fenway and the four executives. The use of the consulting agreements allegedly precluded the portfolio companies from offsetting their monitoring fees with the fund advisory fee, resulting in a greater advisory fee for Fenway. Fenway also allegedly failed to adequately disclose other conflicts of interest, including that an affiliate would receive $1 million out of funds requested from investors in connection with a potential investment and that certain executives were part of a portfolio company's cash incentive plan through which they received $15 million in proceeds from the sale of that company, thereby reducing the fund's return on its investment in that same company.

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(b) Ceresney: "Private equity advisers must be particularly vigilant about conflicts of interest and disclosure when entering into arrangements with affiliates that benefit them at the expense of their fund clients or when receiving payments from portfolio companies."

(c) Fenway agreed to pay $7,892,000 in disgorgement, $824,471.10 in prejudgment interest, and a $1,000,000 penalty to settle the matter. Three of the involved executives paid penalties of $150,000 each and one executive paid a penalty of $75,000 to resolve the claims against them.

3. *In the Matter of Blackstone Management Partners L.L.C., et al.* (Oct. 7, 2015)

(a) The SEC alleged that Blackstone Management Partners LLC ("Blackstone") and certain of its affiliates breached their fiduciary duty to clients by inadequately disclosing certain information to funds and limited partners. Specifically, Blackstone allegedly failed to disclose a discount it received on legal fees being provided to the advisory entities, but not to the funds. In addition, the SEC alleged that Blackstone failed to disclose its ability to accelerate monitoring fees to be paid in the future prior to the submission of capital commitments. The SEC alleged that these accelerating fees had the effect of reducing the value of the portfolio companies prior to their sale. In doing so, the SEC alleged that Blackstone violated Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

(b) The SEC further alleged that Blackstone violated Section 206(4) and Rule 206(4)-7 for inadequate written policies and procedures reasonably designed to prevent conflicts of interest and failure to disclose information regarding monitoring fees.

(c) To settle the matter, Blackstone agreed to pay $26,225,203 in disgorgement, $2,686,553 in prejudgment interest and a $10-million civil penalty.

4. *In the Matter of Kohlberg Kravis Roberts & Co. L.P.* (June 29, 2015)

(a) The SEC alleged that Kohlberg Kravis Roberts & Co. LP ("KKR") breached its fiduciary duty to clients by misallocating expenses. KKR incurred $338 million in expenses, including diligence, research, travel and professional fees, related to potential investment opportunities that ultimately were unsuccessful or went unexecuted. As alleged by the SEC, these broken deal expenses were permitted to be reimbursed through fee-sharing arrangements with KKR's funds and co-investors. The SEC alleged that KKR improperly allocated these expenses by failing to allocate any of them to its co-investors (many of whom were internal firm personnel) and additionally failed to disclose in limited partnership agreements or otherwise that it did not allocate any broken deal expense to its co-investors. By doing so, KKR allegedly breached its fiduciary duty as an investment adviser and Section 206(2) of the Advisers Act.

(b) The SEC also charged KKR with failing to adopt and implement a written compliance policy or procedure regarding its fund expense allocation practices in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The SEC discovered these violations through a 2013 OCIE Compliance Examination.

(c) KKR agreed to pay over $28 million in total to settle the action.

5. *SEC v. Ahmed*, Case 3:15-cv-00675-JBA (D. Conn., May 6, 2015)

(a) The SEC alleged that an individual employed by Oak Investment Partners, a venture capital firm, committed fraud and self-dealing in violation of Section 17(a) of the Securities Act and

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Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Specifically, the SEC's complaint, filed in the District of Connecticut, alleged that the Defendant illegally transferred approximately $27.5 million from fund accounts into accounts under his control, had funds managed by Oak Investment Partners pay inflated prices for certain investments, and failed to disclose his beneficial interest in a company with which the fund transacted.

(b) In connection with the SEC's complaint, the SEC received a temporary restraining order and asset freeze order freezing up to over $55 million in assets.

(c) A month earlier, on April 2, 2015, the SEC filed a complaint against the individual and his friend for their alleged perpetration of an illegal insider trading scheme. The friend allegedly obtained the material non-public information regarding an upcoming acquisition from his wife, the then-general counsel of one of the companies involved in the transaction, and then passed the information to the individual. The individual is also alleged to have subsequently paid the friend $220,000 for the tip. *SEC v. Kanodia and Ahmed*, Case 3:15-cv-00479 (D. Conn., Apr. 2, 2015).

6. *In the Matter of Lincolnshire Management, Inc.* (Sept. 22, 2014)

(a) The SEC alleged that Lincolnshire Management Inc. ("Lincolnshire") breached its fiduciary duty to two of its private equity funds by improperly sharing expenses between different companies in each of the funds' portfolios in a way that benefited one fund over the other.

(b) The SEC also charged Lincolnshire with violating 206(4) of the Advisers Act and Rule 206(4)-7 by failing to adopt and implement written policies and procedures reasonably designed to prevent violations arising from the integration of the two portfolio companies.

(c) Lincolnshire agreed to pay $1.5 million in disgorgement, $358,112 in prejudgment interest, and a $450,000 civil penalty to settle the matter.

IV. Personal/Individual Liability

A. Recent SEC Enforcement Actions Against Individuals

1. The SEC has more frequently been bringing enforcement actions against CCOs of investment advisory firms.

2. In terms of actual enforcement actions, the SEC has come down on both sides of the CCO liability front in 2015.

(a) In *Pekin Singer Strauss Asset Management, Inc. et al.* (June 23, 2015), the SEC alleged that an investment manager had widespread and significant compliance failures, but the CCO was not responsible for them and was not charged by the SEC. To the contrary, the CCO had repeatedly informed upper management that the firm needed to strengthen its compliance program and needed more resources dedicated to compliance. SEC officials have cited this case as an example of a competent CCO not being held liable for the compliance failures of his or her company.

(b) In *BlackRock Advisors, LLC*, the CCO agreed to pay a $60,000 civil penalty for causing his firm's alleged compliance-related violations: failing to adopt and implement written compliance policies and procedures reasonably designed to monitor and disclose conflicts related to outside business activities of firm employees. Specifically, the CCO was held

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partially responsible for a portfolio manager and the principals of the firm failing to disclose a conflict of interest to its funds. Additionally, the CCO was charged with causing some of the adviser's funds to violate Rule 38a-1(a) by not disclosing a "material compliance matter to the funds" boards.

(c) In *SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason* (June 15, 2015), a CCO was charged with causing his firm's alleged failure to implement compliance policies, as well as failure to conduct an annual compliance review, and causing a material misstatement in a Form ADV filing, all of which were related to firm principals allegedly misappropriating client funds through their unilateral signatory power over client bank accounts. Notably, the CCO was held responsible for not implementing policies and procedures reasonably designed to prevent this misappropriation, and for failing to adequately implement the existing policies. The CCO was charged regardless of the fact that when he learned that the misappropriation had occurred, he conducted an internal investigation that resulted in the firing of the individual who misappropriated funds and a referral to criminal authorities. In addition, the CCO was charged with not conducting an annual review in the midst of the internal investigation.

(d) In *Sands Brothers Asset Management et al.* (Nov. 19, 2015), the SEC settled charges with an adviser who allegedly failed to properly distribute audited financial statements to investors in violation of Rule 206(4)-2 ("the Custody Rule"). The CCO was charged with aiding and abetting the alleged violation and failing to implement adequate policies and procedures reasonably designed to prevent these types of violations. In this case, however, the CCO raised these issues directly with management but was ineffective in persuading management to take actions to remedy deficiencies pointed out by the SEC staff.

3. A recent public memorandum by Deputy Attorney General Sally Yates, the second-highest ranking member of the Department of Justice ("DOJ"), announced that the DOJ was formalizing in writing steps intended to strengthen its pursuit of individual corporate wrongdoing, which necessarily includes violations by investment advisers and their employees. Among other things, Yates' memorandum states that in order for an entity to receive credit for cooperating with a government investigation, it must provide all relevant facts relating to the individuals responsible for the misconduct, and all criminal and civil investigations should focus on individuals and their potential liability from the inception of the investigation. Other government regulators, including the SEC and the CFTC, have expressed similar views.

4. All employees — not just CCOs — have a personal interest in preventing compliance failures. Principals and portfolio managers and analysts alike must take personal responsibility for ensuring that the investment adviser is complying with its fiduciary obligations, and that its compliance policies and procedures are properly crafted to address any emerging risks.

5. In a speech in October 2015, Andrew J. Donohue, the SEC's chief of staff, outlined a number of areas that CCOs should focus on in performing their duties:

   (a) The various laws and regulations that govern the manager and its business;

   (b) The manager's compliance policies and procedures and how they are applied and monitored;

   (c) How the manager identifies conflicts of interest, the frequency of any conflicts review, and how conflicts are disclosed, mitigated or resolved;

   (d) The manager's internal operations, supervisory regime, and structure and interdependencies;

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(e) The power and limitations of the manager's compliance and other technology platforms;

(f) The manager's clients, the offering in which they are invested, and their investment objectives;

(g) The types of investment products and strategies in the manager's portfolio;

(h) The practices and regulations in the various markets in which the firm operates; and

(i) The manager's performance across its various products, and how that compares with the corresponding advertising and marketing efforts and materials.

6. Donohue's speech provides a useful guidepost for CCOs attempting to perform their jobs consistently with the SEC's expectations and ensuring that the investment adviser is complying with its fiduciary obligations, including that its compliance policies and procedures are properly crafted to address any emerging risks.

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ALLOCATION OF EXPENSES

Barbash, Breslow and Rozenblit Discuss Hedge Fund Allocations, Restructurings and Advisory Boards

By Vincent Pitaro

Liquidity and performance presentation are only two of the myriad issues facing hedge fund managers. See "*Liquidity and Performance Representations Present Potential Pitfalls for Hedge Fund Managers*" (Mar. 31, 2016). Hedge fund and private equity managers must also be wary of numerous issues that can trigger conflicts of interest or anti-fraud violations, including expense allocations, restructuring and the use of advisory boards. See "*Full Disclosure of Portfolio Company Fee and Payment Arrangements May Reduce Risk of Conflicts and Enforcement Action*" (Nov. 12, 2015).

During the "Issues of the Day for Alternative Asset Managers" program at the Practising Law Institute's recent 2016 Investment Management Institute, panelists discussed these and other topics. Barry P. Barbash, a former Director of the SEC Division of Investment Management and now a partner at Willkie Farr & Gallagher, moderated the program, which featured Stephanie R. Breslow, a partner at Schulte Roth & Zabel; and Igor Rozenblit, co-leader of the Private Funds Unit of the SEC Office of Compliance Inspections and Examinations. This article summarizes the panelists' discussion of these issues.

For additional commentary from Breslow, see "*Schulte Partner Stephanie Breslow Discusses Tools for Managing Hedge Fund Crises Caused by Liquidity Problems, Poor Performance or Regulatory Issues*" (Jan. 9, 2014). For further insight from Rozenblit, see "*SEC's Rozenblit and Law Firm Partners Explain the SEC's Enforcement Priorities and Offer Tips on How Hedge Fund and Private Equity Managers Can Avoid Enforcement Action (Part Three of Four)*" (Jan. 15, 2015).

Overview of the Private Funds Unit

As is customary, Rozenblit cautioned that the views expressed were his own and not those of the SEC or any of its Commissioners. Rozenblit explained that the Private Funds Unit (PFU) is a small team of about 20 individuals within the Office of Compliance Inspections and Examinations that focuses solely on hedge funds and private equity (PE). Its examiners have developed the skills to identify issues more quickly. Its examinations are more focused, and may be "more detailed and more thorough" than other SEC exams. They may also be faster, when the PFU does not spot an issue it is focusing on. For more on the PFU, see "*Current and Former Regulators Advise Hedge Fund Managers on How to Prepare for SEC Exams*" (Feb. 18, 2016).

The PFU looks at incentives that drive manager behavior and takes a thematic approach to examinations. It spends time with industry professionals to conduct "top down, bottom up" analyses, focusing on the overall market at the "top," and individual managers at the "bottom." Rozenblit explained the SEC's National Exam Analytics Tool enables PFU personnel to analyze trade blotters to spot cross trades, valuation changes and other potential red flags.

The PFU has noticed less talk among managers about capital raising and more about "keeping the clients that they have," said Rozenblit. It also sees continuing pressure on management and performance fees. This year is shaping up to be no better than 2015, he added, with particular pressure on credit strategies and funds of funds.

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Poor manager performance, a "glut" of hedge funds, capital draw-downs and decreasing demand for hedge funds are viewed by the PFU as key drivers of hedge fund manager behavior. On the PE side, the PFU has found a bifurcation between PE managers that have no trouble raising capital and those that have "serious problems." It expects the latter category to face the most pressure. Finally, the unit is seeing significant pressure in the high-yield market.

Expense Shifting

Expense shifting is more of an issue for PE funds than for hedge funds, said Rozenblit. See "*Current and Former SEC, DOJ and NY State Attorney General Practitioners Discuss Regulatory and Enforcement Priorities*" (Jan. 14, 2016). In the hedge fund context, one fund may generate all of a manager's soft dollars, but the manager uses those dollars to benefit other funds.

Breslow said that conflicts concerning expenses arise between fund and manager; between fund and fund; and even between classes of the same fund. See "*RCA Compliance, Risk and Enforcement Symposium Examines Ways for Hedge Fund Managers to Mitigate Conflicts of Interest*" (Jan. 21, 2016). A traditional expense disclosure, she said, was that the manager bore its own overhead and that the fund bore all other expenses, "including, but not limited to" a list of specific types of expenses. In response to SEC concerns, that list has become much more detailed over time.

When a manager desires to change its expense practices, Breslow explained, it must first determine whether it requires investor consent. If an expense is a type that an investor would expect to be included in the list provided in existing disclosures, the manager can simply add the expense to the list. If the expense is something that investors would not have expected, the manager must follow the fund's process for obtaining consent. In some cases, managers will notify investors of the proposed change before a redemption date passes, thereby giving them an opportunity to "vote with their feet." See our series on "*How Should Hedge Fund Managers Approach the Allocation of Expenses Among Their Firms and Their Funds?": Part One* (May 2, 2013); and *Part Two* (May 9, 2013).

Managers should also consider the reasonableness of specified expenses, said Breslow, even in funds that pass through all expenses. Rozenblit noted that a "manager-pays-everything" scenario is the easiest situation to evaluate, because there can be no harm to the fund.

Fully passing through expenses raises red flags due to the temptation to put things "that don't belong" into expense buckets. Rozenblit explained that the PFU would certainly take a close look at a fund that paid the cost of the manager's apartment; on the other hand, it might not spend much time considering whether a Bloomberg terminal is used solely by the fund that pays for it. See "*ACA Compliance Report Facilitates Benchmarking of Private Fund Manager Compliance Practices (Part Two of Two)*" (Oct. 11, 2013).

Fund Restructurings

Fund restructurings often occur when a manager is no longer able to raise new capital, said Rozenblit. Managers may offer investors an opportunity to be bought out at a discount, while seeking capital for new investments. These transactions create significant conflicts of interest because without them, the manager is out of business.

One way to effect these transactions is for the manager to sell all of the assets of one fund to a new fund. Another is for limited partners of one fund to sell to other limited partners. An even more difficult situation, said Rozenblit, is when the manager itself buys fund assets, which raises valuation issues and issues under Section 206(3) of the Investment Advisers Act of 1940 (which prohibits principal transactions).

Asset sales are "even more treacherous waters" than tender offers, said Rozenblit, and raise numerous fiduciary duty issues. Such sales are used less frequently. See our two-part series on asset manager M&A transactions: "*Initiating and Structuring M&A*

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Transactions" (May 7, 2015); and "*Taxation, Regulatory and Business Integration Issues*" (May 14, 2015).

Managers have an incentive to keep valuations in restructurings as low as possible, said Rozenblit. Selling investors are often willing to sell at par, and buyers have a great deal of transparency into the portfolio and can more easily value their purchase. A buyer who is getting a "great deal" on assets may be more willing to give the manager a higher fee or more capital to invest.

Breslow tries to ensure that buyers and sellers have access to the same information. A competing concern is that managers may not want to hurt their portfolios by revealing too much information about them. Other concerns, said Rozenblit, include a manager charging a fee on its own restructuring; misrepresentations regarding the health of the portfolio, valuations or the circumstances of the sale; and manipulation of advisory boards.

Advisory Boards

Because a restructuring creates conflicts of interest, a manager may have to seek advisory board approval. See our series on "*How Can Hedge Fund Managers Use Advisory Committees to Manage Conflicts of Interest and Mitigate Operational Risks": Part One* (Apr. 11, 2013); and *Part Two* (Apr. 25, 2013).

One "troubling" situation, said Rozenblit, is when the composition of an advisory board changes prior to the transaction in order to facilitate approval. Breslow noted that, while some managers may try to stack a board with sympathetic people, restructurings may also cause some board members to "flee," because they do not want to be involved in the process.

Rozenblit concurred that pension funds often do not want "to take the liability of making hard decisions." Breslow noted that pensions like the idea of participating in advisory boards because they get a better handle on what is going on at the fund, but they may not want to stay "when things get ugly."

Advisory board composition is a contractual issue, not a regulatory one, said Breslow. Fund documents usually provide that advisory board members may act in their own interests and are not liable to the fund except for bad faith acts.

A board is not usually composed of the manager's "friends and family"; its members tend to be representatives of a fund's largest investors, which often insist on a seat. In Breslow's view, this is a way that "real investors with real skin in the game get to face the manager and deal with conflicts."

The interests of large investors may not be aligned with those of smaller investors, Rozenblit cautioned. Large investors may be seeking other opportunities with the manager – such as co-investments or mezzanine lending – which might make them more willing to approve a new expense pass-through (or other matters) than other investors.

Over-Disclosure and Form ADV

The PFU has noted some "over-disclosure" by PE firms on Form ADV, said Rozenblit. Many funds make disclosures, apparently on the advice of their counsel, as to practices in which they do not engage and have no intention of engaging.

Other issues concern Item 2 of Form ADV Part 2, which is disclosure of material changes. Some firms make changes to their brochure without disclosing the change in that Item. Others move Item 2 with bad news all the way to the back of Part 2.

Enforcement Actions vs. Guidance

In recent years, Breslow noted, SEC enforcement actions have been brought not only against firms that intentionally engaged in illegal behavior, but also against legitimate firms that did not believe that anything they were doing was improper at the time they were doing it. She said industry participants were "wistful" for a time when "the rule would come first and the enforcement [would] come later."

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Rozenblit defended recent SEC actions, arguing that many addressed longstanding industry practices that were never properly disclosed to investors. Enforcement cases, he said, have pushed discussion of "uncomfortable" issues, such as acceleration of monitoring fees, to the forefront. Breslow observed that if the SEC simply provided guidance on some of these issues, it could have had the same impact, without leaving any managers "hanging in the public square." Rozenblit said he would defer to the Division of Enforcement on that issue.

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