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KIRKLANDPEN
Private Equity Newsletter

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Private Fund Manager 2015 Review of Registered Investment Adviser Developments

PENpoints

During the past year, the SEC made finding undisclosed conflicts of interest an examination and enforcement priority.

The year 2015 marked the fifth anniversary of passage of the Dodd-Frank Act and, for many private fund managers, the third anniversary of SEC registration under the Investment Advisers Act. The past year also saw a number of notable SEC regulatory trends and developments affecting private fund managers. Here are the highlights.

Undisclosed Conflicts of Interest

Throughout 2015, the SEC focused on undisclosed conflicts of interest, noting that it would make finding such conflicts an examination priority and that it would follow through with enforcement actions when it found such conflicts. In particular, the SEC keyed in on the following common private equity manager conflicts:

Fees Received by the Fund Manager in Addition to Management Fee and Carried Interest; Accelerated Monitoring Fees. In October 2015, the SEC settled charges with a private equity manager concerning its receipt of accelerated portfolio company monitoring fees arising from sales and IPOs of the portfolio companies, noting that the fund manager failed to disclose the potential fees when the fund was formed and to mitigate the conflict resulting from receipt of fees that did not fully match services actually performed. Following this settlement, the Director of SEC's Division of Enforcement stated: "Full transparency of fees and conflicts of interest is critical in the private equity industry and we will continue taking action against advisers that do not adequately disclose their fees and expenses."[1]

Use of Affiliated Service Providers. In November 2015, the SEC settled charges with a private equity manager and four of its executives over failures to disclose conflicts arising from the manager's conversion of partially off-settable (against the fund's management fee to the manager) portfolio company monitoring fees to non-off-settable payments to a manager-affiliated consulting firm and former employees of the manager. The order noted that the payments were not authorized in the fund's organizational documents or subject to other conflict mitigation (e.g., advisory board approval). A number of SEC examinations of private fund managers have resulted in SEC staff questioning disclosure and conflict mitigation practices relating to use of affiliated service providers, including operating partners.[2]

Allocation of Expenses Between Managers and Funds. In examinations, the SEC has frequently focused on whether expenses are properly chargeable to the private fund rather than to the manager, including, among others, expenses relating to limited partner meetings and related manager travel (particularly private and chartered travel), other manager travel and conference attendance, limited partner reporting/accounting software and use of consultants (particularly those that look like quasi-investment personnel). Consistent with these examination priorities, the SEC brought the following enforcement actions:

- In April 2015, the SEC settled charges with a private fund manager over use of fund assets to pay salaries and benefits, rent, parking, utilities and other manager-related operating expenses in a manner not authorized under the funds' operating documents and not accurately reflected in the funds' financial statements.[3]

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1 See October 13, 2015 *KirklandPEN*, "Private Fund Manager Settles SEC Enforcement Case for Accelerated Monitoring Fees and Service Provider Discounts," for our detailed analysis of this matter. See also SEC Consent Order and Press Release.

2 See November 6, 2015 *KirklandAIM*, "Private Fund Manager and its Executives Settle SEC Enforcement Case for Conflict of Interest Disclosure Failures," for further analysis of this matter, as well as the SEC Consent Order and Press Release.

3 *In the Matter of Alpha Titans, LLC, Timothy P. McCormack, and Kelly D. Kaeser, Esq.* (April 29, 2015). See SEC Consent Order and Press Release.

• In November 2015, the SEC entered into a consent order against two affiliated private fund managers based on their allocation of Advisers Act registration, compliance, examination and enforcement inquiry costs to their private funds rather than to the managers.[4]

• In October 2015, the SEC settled charges with a private fund manager over the manager's receipt of a higher discount rate for manager-related legal services than the discount rate received by its funds for deal work.

Allocation of Investment Expenses. The SEC is generally concerned about fair and equitable allocation of expenses among funds and whether certain "preferred clients" (e.g., regular co-investors and employee/executive funds) are bearing their pro rata portion of, e.g., broken-deal expenses and organizational expenses. In June 2015, the SEC settled charges with a private fund manager on the grounds that the manager generally did not allocate broken-deal expenses to co-investors and did not disclose this practice in its funds' limited partnership agreements or marketing materials.[5]

Allocation of Investment Opportunities. In 2015, the SEC also noted in speeches and other public statements the potential for conflicts in connection with allocation of investment opportunities. Different fee structures among funds may affect a manager's allocation incentives, potential co-investors may be given a co-investment opportunity in exchange for an increased or future commitment, or a manager may otherwise improperly favor certain limited partners over others. Co-investments can be problematic when a firm's practices are not adequately disclosed or an allocation is made in contravention of an allocation policy or a fund's governing documents.

Outside Business Activities and Personal Investing. In August 2015, the SEC settled charges with a private fund manager for failing to disclose a loan made by a client to one of its senior executives before the manager invested certain of its other clients' money in two transactions on different terms than those received by the lender-client.[6] Earlier in 2015, the SEC also settled charges with an adviser to a registered fund in connection with the adviser's failure to disclose and manage conflicts of interest involving outside business activities of one of its senior investment personnel.[7]

Cybersecurity

In September 2015, the SEC examination staff announced an initiative to focus on cybersecurity,[8] and there has been increased SEC dialogue surrounding how advisers store and protect individual customer information and other electronic data. Recent SEC statements and guidance have focused on the initial identification and periodic assessment of cybersecurity risks, unauthorized access, data removal, unauthorized transfers, identity theft, business continuity, networks and physical devices, controls on access to systems and data, vendor security and written information security policies and related training.

In October 2015, the SEC settled charges against an investment adviser for failure to adopt cybersecurity controls where the adviser had posted personally identifiable information, including client information, to a third party-hosted web server that was hacked, even though it was not determined that the personally identifiable information had been compromised and there was no evidence of financial loss by any client.[9]

Chief Compliance Officer Liability

In 2015, the SEC increased its focus on the role of the Chief Compliance Officer ("CCO"), including naming CCOs in settlement orders and subjecting them to monetary penalties. While SEC Commissioners have noted that a CCO performing his or her job diligently and in good faith should not be the subject of enforce-

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4 See November 10, 2015 *KirklandAIM*, "SEC Brings Enforcement Action for Adviser Charging Registration and Compliance Expenses to Private Fund," for further analysis of this topic, as well as the SEC Consent Order.

5 *In the Matter of Kohlberg Kravis Roberts & Co. L.P.* (June 29, 2015). See SEC Consent Order and Press Release.

6 *In the Matter of Guggenheim Partners Investment Management, LLC* (August 10, 2015). See SEC Consent Order and Press Release.

7 *In the Matter of BlackRock Advisors, LLC and Bartholomew A. Battista* (April 20, 2015). See SEC Consent Order and Press Release.

8 See September 21, 2015 *KirklandAIM*, "SEC's 2015 Cybersecurity Examination Initiative for Investment Advisers," for further analysis of this topic, as well as the SEC Office of Compliance Inspections and Examinations National Exam Program Risk Alert, September 15, 2015.

9 See September 24, 2015 *KirklandAIM*, "SEC Brings Cybersecurity Enforcement Action Against Registered Adviser," for further analysis of this topic, as well as the SEC Consent Order and Press Release.

ment actions, liability could arise where a CCO engages in affirmative misconduct, misleads regulators or fails "entirely to carry out [his or her] compliance responsibilities."

Outlook for 2016

A private fund's registered manager should expect a continued challenging regulatory environment, including longer and more intrusive SEC examinations, potentially increased SEC enforcement actions against private fund managers, challenges in obtaining related waivers from SEC bad actor restrictions on fundraising, and new or proposed regulation.[10] A private fund manager raising a new fund should consider the SEC's recent focus on disclosures of conflicts, including fee and expense matters, to investors at the time of the fund's offering (e.g., in the private placement memorandum and/or fund partnership agreement).

10 For example, in 2015 the SEC and other regulators also proposed technical rules on a number of topics that have not been finalized, including those relating to Form ADV disclosure, anti-money laundering and the definition of "accredited investor."

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

Director Removal Without Cause — Delaware Default Rule is in Fact the Rule

A recent Delaware Chancery Court decision held that a company's charter or bylaws could not override the default rule under Delaware law that directors serving on a non-classified board (i.e., annually elected) may be removed with or without cause by a vote of a majority of voting shares. The court did not address, however, whether a charter or bylaw provision could change the required vote (e.g., two-thirds or 75% vote) to effect a removal. To learn more, see our recent M&A Update.

PENnotes

Drafting and Negotiating Corporate Agreements 2016
New York, New York, January 8, 2016
Chicago, Illinois, February 4, 2016

This PLI seminar will teach the basics of drafting and negotiating corporate agreements — from how the provisions of an agreement fit together, to the fundamental drafting and negotiating principles common to all corporate agreements. Kirkland partner Kevin Morris is co-chair of the Chicago event and partners Keith Crow and Sarkis Jebejian will be panelists at the Chicago and New York events, respectively. Click here for more information.

43rd Annual Securities Regulation Institute
Coronado, California, January 25-27, 2016

Hosted by Northwestern Law, the 43rd Annual Securities Regulation Institute will take place in Coronado, California. One of the most visible and highly regarded securities and corporate law conferences in the country, the Securities Regulation Institute reaches prominent attorneys from both firm and in-house practices. Kirkland partner Robert Khuzami will be a panel member for the Enforcement and Government Investigations session. Click here for more information.

15th Annual Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, Illinois, February 19, 2016

Kirkland is a sponsor of the Chicago Booth Private Equity Conference (PEC), an annual event that brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year's conference is themed "Navigating Industry Cycles: Investing in an Evolving Market." Click here for more information.

Columbia Business School's 22nd Annual Private Equity & Venture Capital Conference
New York, New York, February 19, 2016

Kirkland will sponsor Columbia Business School's 22nd Annual Private Equity & Venture Capital Conference, which will focus on the emerging challenges and opportunities facing the private equity and venture capital industries in the coming year. The event will bring together industry professionals, students, alumni and faculty to share their knowledge and experiences. Kirkland partners Daniel Lavon-Krein, Paul Watt and Sean Rodgers will give a lunchtime presentation on sales of minority interests. Click here for more information.

11th Annual Stern Private Equity Conference
New York, New York, March 4, 2016

Kirkland will sponsor New York University's Stern School of Business' 11th Annual Stern Private Equity Conference. The conference will provide a forum for industry leaders to discuss the opportunities and risks of today's private equity and venture capital environment, including how tepid global growth, regulatory dynamics, political pressure and financial market conditions are posing challenges to fundraising, deal financing and operations. Kirkland partner Christopher Torrente will speak on the LBO panel and partner Andrew Calder will be on the Energy panel.

22nd Annual Harvard Business School Venture Capital and Private Equity Conference
Boston, Massachusetts, March 5, 2016

Kirkland will sponsor Harvard Business School's 22nd Annual Venture Capital and Private Equity Conference, held on the Harvard campus. The panels will address a range of today's most relevant topics, from growth equity investing and fundraising to geography-specific investment opportunities. Kirkland partner Nicole Washington will speak on the Diversity in Private Equity panel and partner Armand Della Monica will speak on the State of the Private Equity Industry panel.

17th Annual IBA International Conference on Private Investment Funds
London, England, March 6-8, 2016
Kirkland is a sponsor of the International Bar Association's International Conference on Private Investment Funds, which brings together top legal, business and fund professionals from around the globe to analyze the current market and future of private investment funds, and the prospects of changes and updates to regulatory and tax regimes, among other topics. Partner Daniel Lavon-Krein is on the planning committee for the event. Click here for more information.

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Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013, 2014 and 2015 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland was named "Law Firm of the Year in Mergers and Acquisitions Law" by U.S. News Media Group and Best Lawyers in its 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "North American Law Firm of the Year: Fund Formation" and "North American Law Firm of the Year: Transactions" at *Private Equity International*'s 2014 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012, 2013* and *2014*, and has consistently received top rankings among law firms in Private Equity by The Legal 500 and IFLR, among others.

The Lawyer has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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