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2018 Review: SEC Continues Active Oversight of Registered Private Fund Managers

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In 2018, the first full year with Chairman Clayton at the helm of the Securities and Exchange Commission ("SEC"), private fund managers continued to receive significant attention from the SEC's Office of Compliance Inspections and Examinations ("OCIE") and Division of Enforcement, notwithstanding the SEC's stated focus on retail investment managers. Highlights of the SEC's activity in the private fund space and certain other regulatory developments affecting private fund managers are discussed below.

SEC Continues to Bring Significant Enforcement Actions Against Private Fund Managers

In 2018, the SEC continued to bring a significant number of enforcement actions against private fund managers, including the following:

- *Allocation of expenses to and fee-sharing arrangements with co-investors.* In December 2018, the SEC settled charges with a PE fund manager over its failure to allocate expenses to employee funds and co-investors investing alongside the manager's flagship funds, noting in the consent order that the flagship funds' organizational documents failed to disclose that employee funds and co-investors would not bear their proportional share of expenses. Additionally, the manager failed to disclose arrangements it made with co-investors to share portfolio company fees, where such co-investors did not provide services to the portfolio companies and such arrangements resulted in the flagship funds paying higher management fees because fees shared with co-investors did not offset the flagship funds'

management fees. Notably, the SEC acknowledged that the manager, prior to being contacted by the SEC's Division of Enforcement, had fully reimbursed the misallocated expenses and shared portfolio company fees dating back to 2001 (over a decade after the five-year statute of limitations on the SEC's disgorgement remedy), yet still ended up settling with the SEC and paying a civil penalty.

- *Use of operations groups; in-house charges; service provider conflicts.* In December 2018, the SEC settled charges with a PE fund manager whose funds made minority investments in other private fund managers. The consent order noted that the manager allocated the full cost of its "business services platform" (i.e., an operations group), which it created to provide operational consulting services to the alternative investment firms in which its funds invested, to its funds, although a percentage of the operations group employees' time was spent performing services for the manager instead of the firms the funds invested in (e.g., capital raising and deal sourcing for the manager's funds). In December 2018, the SEC also settled charges with a PE fund manager for charging the preparation cost of its funds' tax returns by the manager's in-house personnel to the funds without specific authorizing disclosure, as well as for failing to adequately track or allocate the expenses of two consulting firms between the manager and its funds (or among its funds). Further, that consent order noted that the manager failed to disclose conflicts related to the manager's relationship with these consulting firms, resulting in expense allocation decisions that posed actual or potential conflicts of interest, including a (i) personal loan made by the manager's principal to a consulting firm, secured by money owed by the manager and the funds, which was repaid with consulting fees paid by one of the manager's funds; and (ii) services relationship between the manager's principal and a consulting firm that was also providing services to the funds and, while such consulting firm was servicing the funds, the manager's principal made a personal investment in the firm.
- *Preferential arrangement with group purchasing organization.* In April 2018, the SEC settled charges with a PE fund manager for failing to disclose conflicts of interest related to its arrangement with a third-party group purchasing organization ("GPO"), a company that aggregates portfolio companies' spending to obtain volume discounts from participating vendors, where the GPO compensated the manager based on a share of the fees received from vendors in connection with purchases by the funds' portfolio companies through the GPO.
- *Failure to apply fee offsets.* The SEC continued its focus on fee and expense practices, settling charges with a private fund manager in June 2018 over its failure to offset consulting fees received from portfolio companies against fund management fees, as required by its funds' governing documents.
- *Accelerated monitoring fees.* The SEC continued its focus on accelerated monitoring fees in 2018, bringing its fourth high-profile case in as many years, and continuing to

target a lack of specific, pre-commitment disclosure of such fees to all fund investors. Most recently, in June 2018, the SEC settled charges with a PE fund manager despite the manager disclosing its accelerated monitoring fee practices in its funds' semi-annual financial reports and side letters with many, but not all, investors.

- *Failure to disclose material information in connection with purchase of fund interests.* The SEC settled charges with a PE fund manager and the manager's principal in September 2018 in connection with the principal's purchase of limited partner interests from fund investors based on stale year-end pricing, when the manager and its principal had received financial information indicating a materially higher valuation since year-end.
- *General advertising and solicitation.* An unregistered private fund manager settled charges with the SEC in September 2018 in connection with, among other things, its failure to comply with Regulation D's prohibition on general advertising and solicitation when it engaged in general solicitation of a private cryptocurrency fund offering through its website, social media accounts and traditional media outlets. In addition to paying a civil penalty, the manager was required to make a rescission offering to each investor in the fund.
- *Political contributions.* The SEC settled charges with three investment managers in July 2018 in connection with violations of the SEC's Political Contributions or "Pay-to-Play" Rule, reflecting the SEC's ongoing focus on prohibited political contributions.[1] Similar to several earlier Pay-to-Play Rule cases, some of the 2018 cases involved modest contributions that were returned to the donor. Additionally, in June 2018, following a lengthy application process, the SEC granted exemptive relief to a fund manager in connection with its violation of the Pay-to-Play Rule stemming from a $2,700 contribution by an executive of the manager to an incumbent state governor running for President, permitting the manager to retain approximately $37 million in advisory fees that would have been subject to forfeiture absent such relief.[2]
- *Insider trading.* The SEC continued its longstanding focus on pursuing insider trading actions, including cases against private fund managers for failing to establish, maintain and enforce policies and procedures to prevent insider trading. In May 2018, the SEC settled charges with a private fund manager after two of its portfolio managers made trades based on material nonpublic information ("MNPI") received from outside consultants where the manager failed to enforce its insider trading policies regarding the use of, and failed to monitor employees' communications with, these consultants. Specifically, the consent order noted that the manager failed to ensure employees were following a checklist the manager had adopted for resolving insider trading concerns. In December 2018, the SEC settled charges with a manager to private funds and business development companies ("BDCs") in connection with

its failure to maintain policies and procedures to address its potential use of one of its client's MNPI for the benefit of another client, noting in the consent order that the manager previously indicated that it seeks to leverage information flow generated by its BDC clients for its private fund clients.[3]

- *"Broken windows" cases.* Although the current administration has given some indication it may be shifting away from the prior SEC administration's touted strategy of pursuing small, "broken window" violations, the SEC brought a number of cases in 2018 against private fund managers related to minor and/or technical infractions, including cases involving technical violations of the SEC's Custody Rule[4] and the failure to file Form PF.[5]

Update on Impact of *Kokesh* Five-Year Statute of Limitations on Disgorgement

The Division of Enforcement's 2018 annual report highlighted the impact of the 2017 unanimous Supreme Court decision in *Kokesh v. SEC* on the Division's activity. The report estimated that *Kokesh*, which generally limits the SEC's ability to obtain disgorgement more than five years after the underlying violations, resulted in the SEC foregoing approximately $900 million it would have otherwise sought since the *Kokesh* decision.[6]

Modest Increase in SEC Exams; Additional Resources Allocated to Oversight of Investment Advisers

As expected, unlike the more than 40% increase in the number of investment adviser examinations in 2017, the SEC's fiscal year ended September 30, 2018 saw a modest 11% increase in the number of such exams. Additionally, the SEC's 2019 budget request to Congress sought 13 restored positions that would focus on examinations of investment advisers and investment companies with the stated goal of improving overall examination coverage of investment advisers, including an emphasis on the nearly 35% of advisers who have never been examined, and, similar to its 2018 budget request, more than 50% of the SEC's 2019 budget plan is allocated to its examination and enforcement programs. We have continued to see private fund registered adviser examinations at approximately the same frequency as prior years.

Other Notable Developments

- *Proposed SEC Fiduciary Rule and Regulation Best Interest.* In April 2018, the SEC proposed a package of rulemakings and interpretations intended, among other things, to codify and reaffirm (and, in some cases, clarify) the fiduciary duties investment advisers owe their clients under the Advisers Act. Specifically, the proposal highlights: (i) the "duty of care," which generally requires an adviser to provide advice that is in its clients' best interest, seek best execution of public securities transactions and to act and provide advice and monitoring over the course of a relationship with a client; and (ii) the "duty of loyalty," which generally requires an adviser to put its clients' interests ahead of its own, avoid unfairly favoring one client over another, make full and fair disclosure of material facts and seek to avoid, and otherwise make full and fair disclosure of, material conflicts of interest with clients.

- *Electronic messaging.* The SEC showed a focus on advisers' use of electronic messaging for business purposes and, in December 2018, OCIE issued a risk alert reminding advisers of their obligations when using various forms of electronic messaging (e.g., text messaging, instant messaging, personal and private email, etc.) to conduct business.[7]

- *Advisory fees and expenses.* The SEC remains focused on fee and expense practices and, in April 2018, OCIE issued a risk alert detailing frequent advisory fee and expense compliance issues identified in examinations of registered advisers, such as applying incorrect fees (e.g., charging carried interest to investors who were not "qualified clients" under the Advisers Act), omitting credits or rebates or applying discounts incorrectly, and misallocating certain adviser expenses to clients (e.g., regulatory filing fees, certain travel expenses, etc.).[8]

- *EU and State Privacy Laws.* The EU's wide-sweeping General Data Protection Regulation ("GDPR") became enforceable in May 2018. Notably, GDPR has extra-territorial reach, applying to all "processing" (e.g., collection, recording, use, etc.) of "personal data" (e.g., name, identification number, online identifier, etc.) relating to individuals in the EU regardless of whether processing takes place in the EU. As such, GDPR may reach U.S. private fund managers whose funds include EU-based investors even if a manager maintains no offices or operations in the EU.

  Additionally, a new California privacy law enacted in 2018 (effective January 1, 2020) potentially will impact private fund managers (and their portfolio companies) doing business in California with gross revenue in excess of $25 million, including managers not located in California whose funds include California-based investors.

Additional changes are likely to be made to the law before its effective date, but the new law generally would require affected managers to update their privacy practices and business processes to accommodate new consumer privacy rights. Notably, a recent amendment to the law exempts most personal information collected and used pursuant to the Gramm-Leach-Bliley Act, which is currently applicable to most private fund managers. It is also worth monitoring whether other states follow California's lead and enact similarly expansive privacy laws.

- *Increase in BDC Leverage Limits.* As part of the Consolidated Appropriations Act, 2018, the permitted leverage ratio of total debt to equity for BDCs was increased from one-to-one to two-to-one, a significant development for private equity and private credit managers operating or interested in operating BDCs.

- *Cayman AML.* In 2018, the scope of Cayman Islands' Anti-Money Laundering Regulations ("Cayman AML Regulations") was expanded to reach private funds, including private equity, venture and real estate funds domiciled in the Cayman Islands that are not registered with the Cayman Islands Monetary Authority. A key component of the updated Cayman AML Regulations included a requirement for Cayman funds to designate, by December 31, 2018, natural persons at a managerial level to serve as: (i) Anti-Money Laundering Compliance Officer; (ii) Money Laundering Reporting Officer; and (iii) Deputy Money Laundering Reporting Officer. Cayman Islands-domiciled private funds also are required to maintain policies and procedures for risk-based due diligence on investors.

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1. See SEC Consent Order, Consent Order and Consent Order.↩

2. See June 28, 2018 *Kirkland AIM*, "Exemptive Relief Granted Under the Political Contributions Rule After Clearing Significant Procedural Hurdles," SEC Notice and SEC Exemptive Order.↩

3. See December 11, 2018 *Kirkland AIM*, "SEC Settles with Investment Adviser Over Expense Allocations, Valuations Issues and Failure to Address the Potential Misuse of Material Non-Public Information between Clients."↩

4. See SEC Consent Order, Consent Order and Press Release.↩

5. See June 8, 2018 *KirklandPEN*, "SEC Charges 13 Private Fund Advisers for Repeated Filing Failures" and SEC Press Release.↩

6. See November 7, 2018 *Kirkland AIM*, "SEC's Division of Enforcement Issues its FY 2018 Results." For additional detail regarding *Kokesh v. SEC*, see June 6, 2017 *Kirkland AIM*, "Supreme Court Limits SEC Disgorgement Remedy

to Five Years."↩

7. See December 20, 2018 *Kirkland AIM*, "OCIE Risk Alert Relating to Electronic Messaging."↩

8. See April 13, 2018 *Kirkland AIM*, "SEC Risk Alert Cites Frequent Advisory Fee and Expense Compliance Issues."↩

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Suggested Reading

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