THE SECURITIES LITIGATION REVIEW

Sixth Edition

Editor
William Savitt

THE LAWREVIEWS

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PREFACE

This sixth edition of *The Securities Litigation Review* is a guided introduction to the international varieties of enforcing rights related to the issuance and exchange of publicly traded securities.

Unlike most of its sister international surveys, this review focuses on litigation – how rights are created and vindicated against the backdrop of courtroom proceedings. Accordingly, this volume amounts to a cross-cultural review of the disputing process. While the subject matter is limited to securities litigation, which may well be the world's most economically significant form of litigation, any survey of litigation is in great part a survey of procedure as much as substance.

As the chapters that follow make clear, there is great international variety in private litigation procedure as a tool for securities enforcement. At one extreme is the United States, with its broad access to courts, relatively permissive pleading requirements, expansive pretrial discovery rules, readily available class action principles and generous fee incentives for plaintiffs' lawyers. At the other extreme lie jurisdictions such as Sweden, where private securities litigation is narrowly circumscribed by statute and practice, and accordingly quite rare. As the survey reveals, there are many intermediate points in this continuum, as each jurisdiction has evolved a private enforcement regime reflecting its underlying civil litigation system, as well as the imperatives of its securities markets.

This review reveals an equally broad variety of public enforcement regimes. Canada's highly decentralised system of provincial regulation contrasts with Brazil's Securities Commission, a powerful centralised regulator that is primarily responsible for creating and enforcing Brazil's securities rules. Every country has its own idiosyncratic mixture of securities lawmaking institutions; each provides a role for self-regulating bodies and stock exchanges but no two systems are alike. And while the European regulatory schemes have worked to harmonise national rules with Europe-wide directives – an effort now challenged by the departure of the United Kingdom from the European Union – few countries outside Europe have significant institutionalised cross-border enforcement mechanisms, public or private.

We should not, however, let the more obvious dissimilarities of the world's securities disputing systems obscure the very significant convergence in the objectives and design of international securities litigation. Nearly every jurisdiction in our survey features a national securities regulatory commission, empowered both to make rules and to enforce them. Nearly every jurisdiction focuses securities regulation on the proper disclosure of investment-related information to allow investors to make informed choices, rather than prescribing substantive investment rules. Nearly every jurisdiction provides both civil penalties that allow wronged investors to recover their losses and criminal penalties designed to punish wrongdoers in the more extreme cases.

Equally notable is the fragmented character of securities regulation in nearly every important jurisdiction. Alongside the powerful national regulators are subsidiary bodies – stock exchanges, quasi-governmental organisations, and trade and professional associations – with special authority to issue rules governing the fair trade of securities and to enforce those rules in court or through regulatory proceedings. Just as the world is a patchwork of securities regulators, so too is virtually each individual jurisdiction.

The ambition of this volume is to provide readers with a point of entry to these wide varieties of regulations, regulatory authorities and enforcement mechanisms. The country-by-country treatments that follow are selective rather than comprehensive, designed to facilitate a sophisticated first look at securities regulation in comparative international perspectives, and to provide a high-level road map for lawyers and their clients confronted with a need to prosecute or defend securities litigation in a jurisdiction far from home.

A further ambition of this review is to observe and report important regulatory and litigation trends, both within and among countries. This perspective reveals several significant patterns that cut across jurisdictions. In the years since the financial crisis of 2008, nearly every jurisdiction reported an across-the-board uptick in securities litigation activity – an increase that will likely be recapitulated by the covid-19 pandemic currently roiling society and the global economy. Many of the countries featured in this volume have seen increased public enforcement, notably including more frequent criminal prosecutions for alleged market manipulation and insider trading, often featuring prosecutors seeking heavy fines and even long prison terms.

Civil securities litigation has continued to be a growth industry as a new normal has set in for the private enforcement of securities laws. While class actions are a predominant feature of US securities litigation, there are signs that aggregated damages claims are making significant inroads elsewhere. Class claims are now well established as part of the regulatory landscape in Australia and Canada, and there appears to be accelerating interest around the world in securities class actions and other forms of economically significant private securities litigation. Whether and where this trend takes hold will be one of the important securities law developments to watch in coming years.

This suggests the final ambition for *The Securities Litigation Review*: to reflect annually where this important area of law has been, and where it is headed. Each chapter contains both a section summarising the year in review – a look back at important recent developments – and an outlook section, looking towards the year ahead. The narrative here, as with the book as a whole, is of both convergence and divergence, continuity and change – with divergence and change particularly predominant in recent years, following political upheaval in the United States and the United Kingdom that has produced a sharp break from international cooperation and forceful government regulation in the global finance capitals of New York and London.

An important example is the matter of cross-border securities litigation, treated by each of our contributors. As economies and commerce in shares become more global, every jurisdiction is confronted with the need to consider cross-border securities litigation. The chapters of this volume show jurisdictions grappling with the problem of adapting national litigation systems to a problem of increasingly international dimensions. How the competing demands of multiple jurisdictions will be satisfied, and how jurisdictions will learn to work with one another in the field of securities regulation, will be a story to watch over the coming years. We look forward to documenting this development and other emerging trends in securities litigation around the world in subsequent editions.

Many thanks to all the superb lawyers who contributed to this sixth edition. For the editor, reviewing these chapters has been a fascinating tour of the securities litigation world, and we hope it will prove to be the same for our readers. Contact information for our contributors is included in Appendix 2. We welcome comments, suggestions and questions, both to create a community of interested practitioners and to ensure that each edition improves on the last.

William Savitt
Wachtell, Lipton, Rosen & Katz
New York
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Chapter 1

SEC ENFORCEMENT: A PRACTICAL GUIDE FOR PRIVATE EQUITY FUND MANAGERS

Eva Ciko Carman, Jason E Brown, Kirsten Boreen Liedl and Daniel Flaherty[1]

I INTRODUCTION

In recent years, the Securities and Exchange Commission (SEC) has brought a variety of highly publicised enforcement actions against private equity firms. By virtue of the long-tail nature of private equity investments, the cases focus on conflicts arising years after the original investment. Accordingly, these cases were not charged as standard fraud-in-the-sale cases but, rather, were pursued as cases sounding in breach of fiduciary duty. The focus on these cases led to a host of settlements that shed light on the SEC's current perspective on pursuing private funds and on the development of breach of fiduciary duty principles. These principles are relevant across the spectrum of private funds, including digital asset, real estate, debt and hedge funds. Although the SEC's priorities for 2020 continue to include focusing on retail investors, the SEC shows no signs of slowing its enforcement actions against private equity fund advisers, and has reaffirmed that it will continue to review conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses and the use of affiliates to provide services to clients.[2] This chapter provides a contextual backdrop for the current enforcement landscape, highlights the key cases and examination trends and offers practical guidance for private fund advisers who wish to assess and remediate their potential vulnerabilities to similar claims.

II BACKGROUND ON CONFLICTS OF INTEREST AND SEC ENFORCEMENT OF THE PRIVATE EQUITY INDUSTRY

Before 2010, with a few exceptions, private equity fund advisers generally did not register with the SEC and, while still subject to the securities laws, largely operated outside the SEC's regulatory regime. Nonetheless, issues within the private equity industry were beginning to be identified by both domestic and international entities. For example, in May 2008, the Technical Committee of the International Organization of Securities Commissions (IOSCO) issued a report setting forth perceived regulatory risks in the private equity industry, including increasing leverage, market abuse, conflicts of interest management, transparency, overall

1 Eva Ciko Carman is a Chambers-ranked securities enforcement lawyer with Ropes & Gray, where she is the co-head of the Ropes & Gray Securities Enforcement Group and Managing partner of the New York Office. Jason E Brown is a *Chambers*-ranked Asset Management partner and a leading member of the firm's regulatory practice. Kirsten Boreen Liedl and Daniel Flaherty are associates focused on regulatory enforcement issues.

2 See SEC Office of Compliance Inspections and Examinations 2020 Examination Priorities, available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

market efficiency, diverse ownership of economic exposure and market access.[3] In November 2009, IOSCO issued a subsequent report focusing on conflicts of interest within the private equity industry, including the use of third-party advisers, lack of disclosure and calculation of fees, which was finalised after public comment in November 2010.[4] In May 2011, the SEC cited IOSCO's final report as a useful public source describing conflicts of interest that private fund advisers may face.[5]

In March 2012, provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became effective. Dodd–Frank extended the registration requirements of the Investment Advisers Act of 1940 (the Advisers Act) to most private equity advisers. Around the same time, the SEC's Division of Enforcement announced the creation of specialised units, such as the Asset Management Unit, to develop expertise on the private equity industry and its common business practices. In addition, the Office of Compliance Inspections and Examinations (OCIE) formed a Private Funds Unit with personnel focusing on private equity firms.

OCIE also began periodic examinations of private equity advisers. In October 2012, in response to the new Dodd–Frank provisions, OCIE began its Presence Exam Initiative among newly registered investment advisers. The purpose of this initiative was, in part, to deepen the SEC's understanding of the private equity industry and better assess the issues and risks associated with this business model. Over the past few years, OCIE has gained added knowledge about the private equity industry by including industry experts from outside the agency on its teams.

Through examinations, OCIE and the SEC more broadly have identified a number of perceived deficiencies within the private equity industry, and have begun providing guidance to assist private equity advisers in bolstering their compliance programmes. A notable example of this guidance was the highly publicised 'Sunshine Speech' by Andrew Bowden, then of OCIE, in May 2014, which made clear that the SEC was focusing, and

3 See Technical Committee of the International Organization of Securities Commissions, 'Private Equity: Final Report' (May 2008), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD274.pdf.

4 See Technical Committee of the International Organization of Securities Commissions, 'Private Equity Conflicts of Interest: Consultation Report' (November 2009), available at www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf; Technical Committee of the International Organization of Securities Commissions, 'Private Equity Conflicts of Interest: Final Report' (November 2010), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf.

5 See Carlo V di Florio, director of OCIE, 'Private Equity International's Private Fund Compliance' (3 May 2011), available at https://www.sec.gov/news/speech/2011/spch050311cvd.htm#P33_11226.

would continue to focus, on the private equity industry.[6] Similarly, OCIE recently offered an overview of frequent advisory fee and expense compliance issues it encounters, including issues of particular relevance to private equity fund advisers.[7]

One of the common themes discussed in SEC guidance – and seen in examinations and enforcement matters – is that the private equity industry presents unique regulatory challenges and conflicts of interest because of its business model. Private equity investors commit capital for investments that may not produce returns for years. Private equity investors therefore enter into agreements that are intended to govern the terms of their investment throughout the fund's life, which routinely exceeds 10 years. Unlike many other types of investments, it is difficult for an investor to readily withdraw its capital from a private equity fund investment. Moreover, typical investment advisers generally do not wield significant influence over companies in which their clients invest, and when they do, the adviser's control is generally visible to its investors and the public. In contrast, the private equity model allows a private equity adviser to use client funds to obtain a controlling interest in a non-publicly traded company, thereby obtaining significant influence over that company. Private equity advisers frequently are very involved in managing investments, such as serving on the company's board, selecting and monitoring the management team, acting as sounding boards for CEOs, and sometimes assuming management roles. In the Sunshine Speech, Andrew Bowden explained that: '[T]he private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services . . . or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company . . . or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.' Bowden noted that, in his view, this model results in conflicts beyond those faced by typical investment advisers.

Another common theme relates to disclosure. Cases and speeches suggest that, for an adviser to satisfy its fiduciary duty under Section 206 of the Advisers Act, the adviser must disclose all material information at the time investors commit their capital, including potential conflicts of interest. In the SEC's view, limited partnership agreements often contain insufficient disclosure regarding fees and expenses that could be charged to portfolio companies, as well as allocation of these fees and expenses. The SEC has also indicated that private equity advisers have often used consultants, or 'operating partners', who provided consulting services to portfolio companies and were paid directly by portfolio companies or the funds, without sufficient disclosure to investors. There have also been alleged instances of poorly defined valuation procedures, investment strategies and protocols for mitigating

6 See Andrew J Bowden, director of OCIE, 'Spreading Sunshine in Private Equity' (6 May 2014), available at https://www.sec.gov/news/speech/2014--spch05062014ab.html; see also Julie M Riewe, co-chief of Asset Management Unit, Division of Enforcement, 'Conflicts, Conflicts Everywhere' (26 February 2015), available at https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html; Marc Wyatt, acting director of OCIE, 'Private Equity: A Look Back and a Glimpse Ahead' (13 May 2015), available at https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html; Andrew Ceresney, director of Division of Enforcement, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (12 May 2016), available at https://www.sec.gov/news/speech/private-equity-enforcement.html.

7 See OCIE National Exam Program Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified In Examinations of Investment Advisers, (12 April 2018), available at: https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

certain conflicts of interest, including investment and co-investment allocation. Of late, the SEC has signalled interest in potentially inaccurate or inadequate disclosures of emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social and governance criteria.[8] In this context, the SEC has suggested that the private equity industry has suffered from an overall lack of transparency. In the SEC's view, some limited partnership agreements do not provide investors with sufficient information to be able to monitor their investments and the investments of their adviser. Although investors engage in substantial due diligence prior to investing in a fund, because of the unique nature of the private equity model, there has rarely been meaningful investor oversight after closing. This limited oversight has the potential to increase the inherent temptations and risks already present within the private equity model.

Finally, much of the SEC's focus in the private equity industry has been on conflicts of interest. In a February 2015 speech,[9] the SEC said that nearly all SEC enforcement matters involve examining whether an adviser has a conflict of interest and, if so, whether the adviser eliminated or disclosed that conflict. According to the SEC, conflicts of interest include situations where there is a 'facial incompatibility of interests, as well as any situation where an adviser's interests might potentially incline the adviser to act in a way that places its interests above clients' interests, intentionally or otherwise'. Notably, under this model, a conflict of interest does not require that an investor be harmed by the conflict, or that the adviser intended to cause harm to the investor. It only requires the possibility that an investment adviser's interests could run counter to those of its investors.

As a result of the SEC's highly publicised focus on the private equity industry, investment advisers have been reviewing and changing their practices. However, the SEC's enforcement efforts and focus on the private equity industry have continued and evolved.

The SEC has long categorised its continued enforcement efforts to focus on three groups: advisers that receive undisclosed fees and expenses; advisers that impermissibly shift and misallocate expenses; and advisers that fail to adequately disclose conflicts of interest.[10] These areas of enforcement are still relevant today, as the SEC's understanding of the adequacy of disclosures and potential for conflicts of interest develops alongside shifts in industry practice. Further, these areas are informative to not only the private equity industry, but also other types of investment advisers who are evaluating their practices and procedures, including those focused on digital assets, real estate, debt and hedge funds. While conflicts of interests were not historically the focus of hedge fund exams, over the past few years, examiners have begun to ask conflict-focused questions – focused on allocation of expenses, allocation of investment opportunities and other conflicts arising, particularly where the hedge fund has a related private equity or debt manager. It is, therefore, important for all advisers to have an understanding of relevant areas of SEC enforcement and potential conflicts of interest, which are described in more detail below.

8 See above, footnote 2.

9 See above, footnote 6.

10 *Id.*

III CONFLICTS OF INTEREST

The SEC's interest in the private equity industry encompasses a wide range of topics, from the highly publicised accelerated monitoring fee issue to the lesser-known conflicts-of-interest issues brought up in examinations. Private equity advisers should be aware of significant areas of enforcement that have increasingly been a subject of SEC focus over the past few years, including undisclosed fees and expenses, misallocation of expenses, valuation of investments and calculation of fees, inadequate disclosure of investments or loans, relationships with third-party service providers, and discounts received from service providers.

While the SEC's enforcement actions cover just a few of the potential conflicts of interest,[11] these actions provide good examples of the SEC's enforcement approach to conflicts and the evolution of obligations arising from Section 206 of the Advisers Act. Notably, under Section 206, the SEC focuses not only on identification of conflicts, but also on the policies and procedures in place for identifying and mitigating such conflicts.

i Undisclosed fees and expenses

The SEC's focus on the receipt of undisclosed fees and expenses has been highly publicised. One very notable example is the practice of obtaining accelerated monitoring fees from portfolio companies, which was highlighted by Andrew Bowden in the Sunshine Speech in 2014.

For instance, in a SEC settlement, the SEC alleged that the adviser terminated monitoring agreements with its portfolio companies and accelerated the monitoring payments in these agreements. The adviser had disclosed that it could receive monitoring fees from portfolio companies, and disclosed the amount of the accelerated fees after they had been collected. However, the SEC alleged that the adviser failed to disclose to investors that it would accelerate payment of future monitoring fees upon the sale or initial public offering (IPO) of a portfolio company. By the time disclosure was made of the accelerated fees, limited partners were already committed to the funds and the fees had been paid. The SEC also noted that certain of the adviser's agreements had 'evergreen' provisions that automatically extended the life of the monitoring agreements for an additional term, and that, on occasion, the adviser received fees that surpassed the length of time that it provided monitoring services to the portfolio company. The SEC therefore alleged that the receipt of the accelerated monitoring fees constituted an undisclosed conflict of interest.

In another example arising during the funds' exit of portfolio positions, the SEC alleged a failure to disclose compensation against MVP Manager, LLC, an unregistered adviser to late-stage venture capital funds.[12] The SEC alleged that, in three instances, MVP principals received brokerage commissions from a counterparty selling pre-IPO company securities to MVP's advisory clients at pre-arranged prices. As described by the SEC, MVP's failure to disclose the commission agreements created an undisclosed conflict because the MVP principals had an economic incentive to recommend that the funds purchase the securities

11 For example, while no enforcement actions have been brought in the private equity space on stapled secondary transactions, these raise potential conflicts on which the SEC has focused during exams.

12 See *In re MVP Manager LLC*, Investment Advisers Act of 1940 Release No. 5319, Administrative Proceeding File No. 3-19334 (13 August 2019), available at https://www.sec.gov/litigation/admin/2019/ia-5319.pdf.

at the negotiated price, in order to trigger their receipt of commissions. To settle these allegations, MVP agreed to pay US$150,059 in disgorgement, US$19,681 in prejudgment interest and a US$80,000 in civil penalty.

The SEC also routinely targets undisclosed compensation resulting from a fund's initial investment. A recent example involved Fortress Investment Management, LLC, the fourth adviser to face charges of undisclosed compensation arising from its funds' investment in the Aequitas enterprise.[13] According to the SEC, Fortress advised a small fund to invest over 95 per cent of its assets into securities issued by an Aequitas entity, without disclosing to the fund's investors that Fortress received $15,000 per month from an Aequitas affiliate for consulting and business development services, which included introducing prospective investors. The fund's documents did disclose that Fortress or its personnel 'may' work for and receive compensation from companies in which the fund invested, but the SEC concluded this disclosure was 'insufficient to allow [investors] to provide informed consent to the actual conflict that existed'. As a result, to settle the charges, Fortress agreed to pay US$104,097 in disgorgement, civil penalties and prejudgment interest, while its principal agreed to a US$50,000 civil penalty and a 12-month suspension from the securities industry.

ii Misallocation of expenses

The SEC has made clear that an adviser is required to allocate expenses so that the expenses are borne appropriately and proportionately by the entity that incurred and benefited from the expenses, unless the arrangement is otherwise disclosed to investors. This situation has arisen in a variety of contexts, such as misallocation of expenses between a fund and the adviser, misallocation of expenses between funds and misallocation of expenses where co-investors have invested in a fund investment.

The SEC has found that an adviser is not permitted to allocate its own operating expenses to funds or portfolio companies if this practice has not been disclosed to investors. For example, in the SEC's settlement with Cherokee Investment Partners and Cherokee Advisers (together, Cherokee),[14] the SEC alleged that Cherokee allocated to its funds US$455,698 in consulting, legal and compliance-related expenses incurred in the course of registering as an investment adviser. Cherokee did not disclose to investors that its funds would be charged for the adviser's legal and compliance expenses. Cherokee ceased this practice in March 2015 and reimbursed the funds for these expenses in April 2015. Nonetheless, because Cherokee had failed to disclose this practice to investors, Cherokee ultimately paid a US$100,000 civil penalty to settle this matter.

Similarly, Potomac Asset Management Company, Inc. (PAMCO) and its president settled allegations that PAMCO, inter alia, improperly used the funds' assets to pay PAMCO's adviser-related expenses, including compensating a member of the investment team, paying

13 See *In re Fortress Investment Management, LLC and William M. Malloy, III*, Investment Advisers Act of 1940 Release No. 5452, Administrative Proceeding File No. 3-19715 (27 February 2020), available at https://www.sec.gov/litigation/admin/2020/ia-5452.pdf;

14 See *In re Cherokee Investment Partners LLC and Cherokee Advisers, LLC*, Investment Advisers Act of 1940 Release No. 4258, Administrative Proceeding File No. 3-16945 (5 November 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4258.pdf.

rent and other expenses, and paying costs associated with PAMCO's regulatory obligations.[15] The funds' governing documents did not authorise or disclose this practice. To settle these allegations with the SEC, PAMCO agreed to pay a civil penalty of US$300,000.

Increasingly, the SEC is focusing on the specificity with which a fund's obligation to bear the adviser's operating expenses has been disclosed. For example, the SEC alleged that First Reserve Management misallocated expenses to funds without making appropriate disclosures or obtaining consent.[16] First, the SEC alleged that First Reserve misallocated the fees and expenses of two entities formed as advisers to a fund portfolio company, which allowed First Reserve to avoid incurring certain expenses in connection with providing advisory services to the funds. Second, the SEC alleged that First Reserve misallocated premiums for a liability insurance policy covering First Reserve for risks not entirely arising from its management of the funds, when the governing fund documents provided that the funds would only pay insurance expenses relating to the affairs of the funds. To resolve these allegations, among others, First Reserve committed to reimbursing the funds and revising its practices and disclosures, and agreed to pay a civil penalty of US$3.5 million.

Similarly, the SEC alleged that Yucaipa Master Manager, LLC, as manager to several private equity funds, improperly charged those funds US$570,198 in expenses related to tax preparation by in-house employees over a five-year period.[17] The SEC recognised that the fund agreements obligated the funds to bear the costs of financial statement and tax return preparation, but nonetheless found that the agreements obligated Yucaipa to bear the costs for its affiliates' normal operating overhead, including employee salaries. Yucaipa's alleged failure to disclose that it would allocate a portion of the salaries of in-house tax employees preparing fund tax returns to the funds, among other alleged failures discussed below, led to an enforcement action ultimately settled for approximately US$3 million.

The SEC also considers the effectiveness of an adviser's expenses allocation procedures to ensure compliance with their disclosures. For example, in a recent case involving a fund-of-funds adviser, the SEC agreed to a US$2.73 million settlement of allegations that, among other conduct, the adviser overcharged three funds for the expenses of management employees by failing to adjust compensation-related expenses for time unrelated to the employees' reimbursable management activity. The funds' governing documents permitted the adviser to charge the funds for the payroll burden of management employees assisting management entities that control the underlying investments of the fund's investments. The SEC alleged that approximately 7 per cent of the nearly US$30 million in expenses the funds paid for that management assistance was charged in error for time spent dealing with general fund administration.

Similarly, in a case alleging wide-ranging compliance failures against Corinthian Capital Group, its CEO and CFO, the SEC commented on Corinthian's improper allocation

15 See *In re Potomac Asset Management Co, Inc. and Goodloe E. Byron, Jr.*, Investment Advisers Act of 1940 Release No. 4766, Administrative Proceeding File No. 3-18168 (11 September 2017), available at https://www.sec.gov/litigation/admin/2017/ia-4766.pdf.

16 See *In re First Reserve Management, LP*, Investment Advisers Act of 1940 Release No. 4529, Administrative Proceeding File No. 3-17538 (14 September 2016), available at https://www.sec.gov/litigation/admin/2016/ia-4529.pdf.

17 See *In re Yucaipa Master Manager, LLC*, Investment Adviser Act of 1940 Release No. 5074, Administrative Proceeding File No. 3-18930 (13 December 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5074.pdf.

of organisational expenses to a fund client.[18] While the SEC noted that the fund's documents permit Corinthian to call capital to pay the fund's organisational expenses, the SEC nonetheless alleged that Corinthian improperly caused the fund to pay organisational expenses by transferring fund assets to itself based on estimated organisational expenses before those expenses were incurred. Further, the SEC alleged Corinthian improperly included placement fees in the amount of organisational expenses, despite their being specifically excluded under the fund documents' definitions. To settle these charges, among others, Corinthian and its executives agreed to pay a civil penalty of US$140,000.

The SEC has also made clear that an adviser must allocate expenses shared by multiple funds proportionately or in compliance with the governing fund documents. For instance, the SEC charged Lincolnshire Management with misallocating expenses between two portfolio companies.[19] Lincolnshire had integrated two portfolio companies and managed them as one company, although the two portfolio companies remained distinct legal entities that were owned by two separate funds. However, the SEC alleged that Lincolnshire allocated a disproportionate share of the companies' joint expenses to one portfolio company, to the detriment of that portfolio company's fund's investors. For example, it claimed one portfolio company paid for third-party administrators to provide payroll services, but both portfolio companies used these services. Similarly, it stated that certain employees did work that benefitted both companies, but their salaries were not allocated between the two companies. Lincolnshire agreed to pay US$1.85 million in disgorgement and prejudgment interest, as well as a civil penalty of US$450,000, to resolve these allegations.

In another matter, the SEC determined that a private equity adviser improperly allocated broken deal expenses, where it was not disclosed that funds would pay broken deal expenses for the portion of the investment that would have been allocated to employee co-investors. Specifically, under the limited partnership agreements and private placement memoranda, the funds were responsible for all expenses of the partnership, including broken deal expenses. The adviser did not disclose, however, that the funds would also pay the broken deal expenses for the portion of each investment that would have been allocated to the adviser's co-investors. As a result, the funds were allocated US$1,811,502 during the relevant time period for broken deal expenses without proper disclosure. The adviser agreed to disgorgement and prejudgment interest of US$1,902,132 and a civil penalty of US$1.5 million to settle these allegations.

iii Valuation and miscalculation of fees

In a similar vein, the SEC has indicated that an adviser is required to accurately calculate its fees, in accordance with disclosures. In light of the illiquid nature of many fund assets, in addition to departures from disclosures, the SEC has expressed concern with the use of bespoke methodologies no investor would reasonably anticipate, and inadequate procedures to guard against inherent conflicts.

18 See *In re Corinthian Capital Group, LLC, Peter B. Van Raalte and David G. Tahan*, Investment Advisers Act of 1940 Release No. 5229, Administrative proceeding File No. 3-19159 (6 May 2019), available at https://www.sec.gov/litigation/admin/2019/ia-5229.pdf.

19 See *In re Lincolnshire Management, Inc.*, Investment Advisers Act of 1940 Release No. 3927, Administrative Proceeding File No. 3-16139 (22 September 2014), available at www.sec.gov/litigation/admin/2014/ia-3927.pdf.

For example, in a matter currently being litigated in federal court, the SEC alleged that Greenpoint Asset Management II, LLC and related advisers improperly charged over US$13 million in management fees.[20] The SEC alleged that such fees resulted from Greenpoint's inflated valuations of a now-worthless portfolio company and a collection of mineral assets. According to the complaint, Greenpoint unreasonably valued the portfolio company at up to 10 times its purchase price, while knowing that a loan in default put all of the company's assets at risk. Further, in contravention of disclosures that mineral assets would be valued by an independent appraiser, Greenpoint allegedly interfered with appraisals to cause higher appraised values.

The SEC also charged ECP Manager LP for continuing to factor in capital committed to worthless assets when calculating management fees, and thereby overcharging its fund investors by approximately US$102,304.[21] The fund's documents allegedly based management fees on capital contributions, but required amounts attributable to worthless assets to be excluded from fee calculations. ECP allegedly included approximately US$3.4 million in capital contributions in fee calculations for a 12-month period, which should have been excluded because they were invested in assets that were written down to zero, and later expired as worthless. ECP agreed to settle these allegations for disgorgement and prejudgment interest of US$122,656 and a civil penalty of US$75,000.

The SEC's focus on valuation extends to other alternative asset classes, which can be instructive for the private equity industry. For example, in its 2019 Enforcement Report, the SEC highlighted as noteworthy a case against Deer Park Road Management Company LP, an adviser with over US$2.5 billion assets under management focused on residential mortgage-backed securities.[22] In that case, the SEC alleged, inter alia, that Deer Park failed to adopt policies reasonably designed to fairly value its funds' assets in light of conflicts arising from Deer Park's traders' relationship with pricing vendors, use of valuation models and discretion to determine the fair value assessment of a portion of the positions they managed. Deer Park also allegedly failed to implement its existing valuation policy. There were no allegations that any assets were actually valued inaccurately or resulted in excessive management fees. Rather, the SEC alleged that Deer Park failed to guard against the risk that traders were improperly influencing valuations with reasonably designed compliance controls. To settle these allegations, Deer Park agreed to engage an independent compliance consultant, and to pay a civil penalty of US$5 million.

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20 See *Securities and Exchange Commission v. Bluepoint Investment Counsel, et al.*, Litigation Release No. 24632 (30 September 2019), available at https://www.sec.gov/litigation/litreleases/2019/lr24632.htm; see also Complaint, *Securities and Exchange Commission v. Bluepoint Investment Counsel, et al.*, No. 3:19-cv-00809 (W.D. Wisc. filed 30 September 2019), available at https://www.sec.gov/litigation/complaints/2019/comp24632.pdf.

21 See *In re ECP Manager LP*, Investment Advisers Act of 1940 Release No. 5373, Administrative Proceeding File No. 3-19535 (27 September 2019), available at https://www.sec.gov/litigation/admin/2019/ia-5373.pdf.

22 See SEC Division of Enforcement 2019 Annual Report, available at: https://www.sec.gov/enforcement-annual-report-2019.pdf, discussing *In re Deer Park Road Management Company, LP and Scott E. Burg*, Investment Advisers Act of 1940 Release No. 5245, Administrative Proceeding File No. 3-19190 (4 June 2019), available at https://www.sec.gov/litigation/admin/2019/ia-5245.pdf.

iv Undisclosed loans and investments

The SEC considers undisclosed loans and investments, as well as misallocation of investment opportunities, to be a potential conflict of interest. The SEC's settlement with JH Partners provides a good example.[23] In that matter, the SEC alleged that JH Partners and certain of its principals provided loans to the funds' portfolio companies, thereby obtaining interests in portfolio companies that were senior to the equity interests held by the funds. JH Partners also allegedly caused more than one of its funds to invest in the same portfolio company at differing priority levels from another fund, which could have potentially favoured one client over another. In the SEC's view, these undisclosed arrangements could have caused the adviser to favour itself or one of its funds over another fund, as a result of its more senior investment position in the portfolio company. The SEC alleged that JH Partners did not adequately disclose the potential conflicts created by these undisclosed loans to the relevant advisory boards. To settle these allegations, among others, JH Partners agreed to pay a civil penalty of US$225,000.

Another example comes from the SEC's settlement with Michael Devlin, former managing partner and CCO of Pharos Capital Group, LLC (Pharos).[24] Devlin allegedly arranged for a Pharos-managed fund to purchase notes from an entity owned by a subsidiary of one of the fund's portfolio companies, and for that subsidiary to use a portion of the proceeds to purchase Devlin's personal interest in the entity issuing the notes. Although the fund ultimately did not lose money on the notes, Pharos failed to disclose this conflict. To settle these allegations, Devlin personally agreed to pay a civil penalty of US$80,000. In addition, he was barred from the securities industry for at least one year, and indefinitely barred from re-entering the industry in a compliance capacity.

Recently, failure to disclose loans, among other allegations such as undisclosed monitoring fees, led the manager of multiple adviser entities, Tyler Tysdal, to agree to a settlement barring him from the securities industry for at least three years and requiring that he pay US$1,163,099 in disgorgement, interest and civil penalties.[25] In relevant part, the SEC alleged that Tysdal directed that money held by one fund, Cobalt, be loaned – without disclosure and against Cobalt's stated strategy – to portfolio companies held by another fund, the Impact Opportunities Fund, and that the Impact Opportunities Fund's debt investments in those portfolio companies be subordinated to the undisclosed loans from Cobalt. The SEC determined that Tysdal's failure to disclose the loan arrangement to the Impact Opportunities Fund investors, or to obtain their prior informed consent, was fraudulent.

23 See *In re JH Partners, LLC*, Investment Advisers Act of 1940 Release No. 4276, Administrative Proceeding File No. 3-16968 (23 November 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4276.pdf.

24 See *In re Michael Devlin*, Investment Advisers Act of 1940 Release No. 4973, Administrative Proceeding File No. 3-18604 (19 July 2018), available at https://www.sec.gov/litigation/admin/2018/ia-4973.pdf.

25 See *In re Tyler Tysdal, et al.*, Investment Advisers Act of 1940 Release No. 5351, Administrative Proceeding File No. 3-19463 (17 September 2019), available at https://www.sec.gov/litigation/admin/2019/33-10687.pdf. This matter also involved undisclosed monitoring fees.

v Undisclosed relationships with third parties

The SEC has also focused in recent years on undisclosed relationships with third parties, including third-party service providers. The SEC has determined that these undisclosed relationships can constitute a conflict of interest, even where the undisclosed relationship does not harm investors.

One recent example of an undisclosed relationship with a third party comes from a resolution with Centre Partners Management.[26] In the settlement order, the SEC alleged that Centre Partners failed to disclose relationships between certain of its principals and a third-party information technology service provider, as well as the potential conflicts of interest resulting from these relationships. Specifically, three of Centre Partners' principals were invested in the service provider, two occupied seats on the provider's board and the wife of one of the principals was a relative of the provider's co-founder and CEO. Although Centre Partners provided extensive disclosure on its use of the service provider and its advantages – and neither Centre Partners nor its principals profited from the relationship – the SEC alleged that the lack of disclosure about the relationships between the provider and the Centre Partners principals constituted a conflict of interest. Put differently, the SEC did not allege any actual conflict (i.e., that the terms were off-market, that the services were not appropriate or that the owners profited from the arrangements). Rather, the SEC asserted that, because this relationship constituted a potential material conflict, it should have been presented to the limited partners' advisory committee under the terms of the limited partnership agreements. To resolve these allegations, Centre Partners agreed to pay a civil penalty of US$50,000.

Similarly, in a case previously mentioned, Yucaipa Master Manager, LLC's principal allegedly made a personal loan of US$215,000 to the principal at a consulting firm (Firm A) engaged by Yucaipa's funds.[27] The loan to Firm A's principal was secured by money that might be owed to Firm A by Yucaipa and its affiliates, and was paid by accelerating and offsetting fees Yucaipa's funds owed to Firm A. The Yucaipa principal also personally invested in another consulting firm (Firm B) servicing both Yucaipa's funds and his own personal investments, and received a right to 25 per cent of Firm B's profits. The investment in Firm B did nothing to change or offset the consulting fees Yucaipa funds paid to Firm B. The SEC alleged that Yucaipa did not adequately disclose the conflicts created by these undisclosed relationships. As part of the multimillion-dollar settlement noted above, the SEC required Yucaipa to engage an independent compliance consultant to, among other issues, review its conflicts of interest policies and procedures.

Recently, Steven Bruce and Charter Capital Management, LLC, settled charges of similar issues with SEC.[28] In that matter, the SEC alleged that Bruce arranged for two funds advised by Charter to make a US$4 million loan to a Norwegian individual and company, without disclosing to the fund investors that Bruce had lent the Norwegian individual

26 See *In re Centre Partners Management, LLC*, Investment Advisers Act of 1940 Release No. 4604, Administrative Proceeding File No. 3-17764 (10 January 2017), available at https://www.sec.gov/litigation/admin/2017/ia-4604.pdf.

27 See above, footnote 17.

28 See *In re Charter Capital Management, LLC, and Steven Morris Bruce*, Investment Advisers Act of 1940 Release No. 5226, Administrative Proceeding File No. 3-19152 (23 April 2019), available at https://www.sec.gov/litigation/admin/2019/ia-5226.pdf.

US$115,000 of his own money. Ultimately, Bruce agreed to settle these allegations by paying a US$40,000 civil penalty, after already having personally refunded investors over US$184,000 during the SEC's investigation.

This focus on conflicts arising from third-party relationships has extended to hedge funds as well. For example, the SEC alleged that Paritosh Gupta shared confidential information obtained from his employment at a hedge fund with his wife, Nehal Chopra, who worked at Ratan Capital Management LP.[29] Gupta also provided investment recommendations and advice to Chopra and Ratan. The SEC alleged that, by sharing Gupta's employer's confidential information, Gupta violated the Advisers Act. In addition, the SEC alleged that Ratan and Chopra failed to disclose Gupta's role to Ratan's investors. To settle these allegations, among others, Gupta, Chopra and Ratan agreed to pay civil penalties of US$250,000, US$200,000 and US$200,000, respectively.

Similarly, in the real estate arena, the SEC recently settled a case with Talimco, LLC on the basis of its failure to disclose relationships with third parties.[30] The SEC alleged that, to satisfy contractual provisions requiring third-party competitive bids, Talimco arranged for third parties to submit bids for mortgage loan participations held by a Talimco-managed Collateralized Debt Obligation (CDO) before that CDO sold the participations to a Talimco-advised fund, while assuring the third parties that they would not win the auction. The SEC did not allege that the price ultimately favoured one Talimco client over the other. Rather, it focused on Talimco's failure to disclose that its interactions with the bidders deprived the investors of the opportunity to obtain a true market check on the loan participations' price. To settle these allegations, Talimco agreed to cooperate in related investigations and pay US$407,759 in disgorgement, interest and civil penalties.

vi Undisclosed discounts from service providers

The SEC has also considered undisclosed discounts received from third-party service providers to be a conflict of interest. In these situations, the SEC has concluded that, because the adviser is receiving an undisclosed benefit in the form of a discount, the adviser cannot consent to the adviser's practice of receiving the discount on behalf of the funds.

For example, in its settlement order with First Reserve Management, LP (discussed earlier), the SEC alleged, inter alia, that First Reserve arranged for a law firm to provide legal services to both First Reserve and its funds from approximately 2010 to 2014, subject to an adviser-level discount not shared by the funds.[31] The law firm provided significantly more legal work, and generated significantly more legal fees, in connection with the services it provided to the funds. As part of this arrangement, First Reserve negotiated a legal fee discount from the law firm for itself that was based on the large volume of work the law firm performed for the funds. First Reserve did not negotiate a similar discount for the funds. Beginning in early 2013, First Reserve began disclosing in its Form ADV that it could receive service provider discounts that might be more favourable than those received by the funds, but did not disclose that it was, in fact, receiving that discount. Following an OCIE

29 See *Paritosh Gupta, Adi Capital Management LLC, Nehal Chopra, and Ratan Capital Management, LP*, Investment Advisers Act of 1940 Release No. 4820, Administrative Proceeding File No. 3-18296 (5 December 2017), available at https://www.sec.gov/litigation/admin/2017/ia-4820.pdf.

30 See *In re Talimco, LLC*, Investment Advisers Act of 1940 Release No. 5202, Administrative Proceeding File No. 3-19108 (15 March 2019), available at https://www.sec.gov/litigation/admin/2019/ia-5202.pdf.

31 See above, footnote 16.

examination, First Reserve agreed to pay to the funds their pro rata share of the discount First Reserve received from the law firm, and to provide investors with information regarding its planned practices to pass through the adviser-level discount to its funds going forward. The SEC still concluded that, because First Reserve was a beneficiary of this discount, the discount resulted in a conflict of interest, and First Reserve could not consent on behalf of the funds to First Reserve's practice of accepting the discount.

In another similar example of an undisclosed service provider discount, the SEC alleged that an adviser negotiated a legal services discount arrangement on behalf of itself and its funds, wherein the adviser received a greater discount on legal services than the funds. The differing discount rates were not disclosed to the funds or the limited partners. The SEC alleged that this practice constituted a conflict of interest.

IV KEY TAKEAWAYS AND PRACTICE TIPS

As investment advisers have begun changing their practices to address and prevent the conflicts of interest that have long been the centre of the SEC's private equity enforcement programme, the SEC shows no signs of shifting its attention from the possible conflicts inherent in the private equity business model, and its wider industry. The SEC's recent statements, examinations and enforcement actions demonstrate the importance of adequate monitoring, evaluation and disclosure of potential conflicts of interest. Both private equity and other types of advisers should evaluate their practices and procedures for any potential conflicts, keeping in mind the following enforcement trends.

i Mitigate, eliminate or disclose conflicts

Advisers should evaluate any potential conflicts that may exist in their practices, procedures or relationships. If any conflicts exist, advisers should determine whether these conflicts have been adequately disclosed or should be mitigated or eliminated. In particular, advisers should examine their fees and expenses charged to funds and portfolio companies to confirm that the fees and expenses have been adequately described in offering agreements or related disclosure documents, or both. Examples of conflicts in the private equity industry can be found in published enforcement actions, public disclosures and SEC guidance and speeches. An adviser's counsel is also a good source of this information. If the conflict is not disclosed in the offering documents, consideration should be given to whether a disclosure to Limited Partners or their Advisory Committees may be an option.

ii Lack of harm or benefit may be irrelevant to liability

The SEC does not consider the fact that limited partners were not harmed – or even received a benefit – to be a complete defence to a potential conflict. Therefore, when an adviser evaluates a practice or relationship to determine whether it constitutes a potential conflict of interest, the relevant metric is not only whether the arrangement is to the limited partners' benefit, but also whether it could appear that the arrangement could affect the adviser's judgment. In the SEC's view, because an adviser is a fiduciary, it must disclose all material conflicts of interest so that the client can evaluate the conflict and make an informed decision for itself. Any benefit or lack of harm to a limited partner does not relieve the adviser of this duty to inform. Notably, however, SEC speeches have suggested that a potential benefit to an investor may be relevant in assessing a potential remedy, even if it is not relevant in assessing the adviser's liability.

iii Focus on both actual and potential conflicts

The SEC is concerned with both actual and potential conflicts. As seen in the *Centre Partners* settlement, the SEC has pursued enforcement in situations where there is no actual conflict but the mere potential for a conflict exists. Therefore, an adviser must proactively evaluate its practices, procedures and relationships to determine whether they could possibly tempt the adviser to act in its own best interest over that of its investors.

iv Disclosures in pre-commitment documents

The SEC has continued to emphasise its view that disclosures regarding potential conflicts of interest should be made in pre-commitment, rather than post-commitment, documents. This includes disclosures in a Form ADV, which have been described in SEC speeches as a 'positive change', but 'not a sufficient remedy'. Post-commitment disclosures have been found generally to be insufficient, according to the SEC, because of the unique nature of the private equity industry. Namely, it is the SEC's view that if limited partners were aware of potential conflicts of interest before committing capital to the fund, they could have bargained for a different arrangement with the adviser. The SEC has generally not been amenable to arguments that it is unfair for advisers to be held accountable for documents drafted long before the SEC began its focus on private equity. The SEC takes the position that private equity advisers have always been investment advisers subject to the Advisers Act, and were therefore fiduciaries subject to the Advisers Act's anti-fraud provisions.[32] Notwithstanding this view, the SEC does appear to take into consideration certain other post-commitment disclosures, including limited partner advisory committee disclosures and consents.

v Detailed disclosures

The SEC expects disclosures to be as detailed as possible. Disclosures involving broad statements in fund documents may be viewed by the SEC as insufficient if a reasonable investor would not have understood the conflict from reading the disclosure. In fact, the SEC has reached out to investors in certain exams and enforcement actions to confirm whether they understood the conflict at issue. In this regard, the SEC has generally rejected arguments that limited partners are sophisticated investors who are aware of industry practices.

V CONCLUSION

The SEC's pursuit of cases in the private equity context has not only shed light on the type of conduct that the SEC views as most problematic, it has also provided invaluable insight into the SEC's views of fiduciary duty principles under Section 206 of the Advisers Act. Going forward, it is likely that these principles will influence how the SEC approaches and assesses the conduct of all types of private fund advisers. Accordingly, firms are well served by understanding the lessons learned in the private equity context, and using that insight to assess their own practices – asking whether their conduct may be perceived to constitute a conflict or potential conflict and if so, whether those conflicts have been adequately disclosed. Operating with this awareness and taking a proactive approach to remedy any shortcomings will serve firms well in ensuring they are prepared when the SEC eventually comes knocking.

32 See above, footnote 6.

Appendix 1

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Eva Carman is the co-head of the Ropes & Gray Securities Enforcement Group and Managing Partner of its New York office. Eva's litigation and regulatory work has received recognition from Best Lawyers in America, Legal 500, Crains and Chambers & Partners, where clients describe her as 'extraordinarily knowledgeable', 'exceptionally smart' and 'superb at what she does'.

Eva has thirty years of experience representing private equity firms, hedge funds, credit funds, mutual funds and broker dealers in addressing their most challenging regulatory and enforcement issues. Firms retain her to lead internal investigations, navigate SEC examinations and defend them in SEC enforcement inquiries. Eva's experience includes leading numerous internal investigations for both public and private boards, assisting clients with more than 200 SEC examinations, and leading the defence of 10 recent enforcement investigations. This breadth of experience, coupled with her knowledge of the industry, makes her a sought after counsellor for some of the world's most sophisticated firms.

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Jason has extensive experience representing investment advisers to private equity funds, real estate funds, credit funds, venture capital funds, hedge funds, separate accounts and commodity pools.

He has assisted numerous leading private equity and real estate firms in registering as investment advisers with the SEC and developing Advisers Act compliance programmes.

Jason has worked with over 90 investment advisers on SEC examinations and regularly advises clients on SEC enforcement actions.

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