The Securities Litigation Review

Seventh Edition

Editor
William Savitt

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SEVENTH EDITION

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PREFACE

This seventh 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. 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 disrupted 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 has been recapitulated by the covid-19 pandemic 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. 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 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 seventh 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
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Chapter 1

SEC ENFORCEMENT: A PRACTICAL GUIDE FOR PRIVATE EQUITY FUND MANAGERS

Eva Ciko Carman, Jason E Brown, Helen Gugel and Daniel Flaherty[1]

I INTRODUCTION

In the 11 years since the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) extended regulatory scrutiny to, and imposed mandatory registration requirements on, most private equity fund advisers, the Securities and Exchange Commission (SEC) has brought a variety of highly publicised enforcement actions against the industry. By virtue of the long-tail nature of private equity investments, the SEC's early cases focused 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 fiduciary duty led to a host of settlements that shed light on the SEC's perspective on pursuing private funds and on the development of breach of fiduciary duty principles in the asset management industry. These principles remain highly relevant across the spectrum of private funds, including digital asset, real estate, debt and hedge funds.

Although the stated priorities for the SEC's Division of Examinations (EXAMS) – formerly, the Office of Compliance Inspections and Examinations (OCIE) – continue the agency's recent focus on retail investors, the SEC shows no signs of slowing its enforcement actions against private equity fund advisers, and has reaffirmed that EXAMS will continue to focus on private fund advisers' compliance programmes, including disclosures of investment risks and conflicts of interest.[2] Indeed, EXAMS will focus its review on conflicts arising from portfolio valuation and resulting fee calculation issues, as well as conflicts related to liquidity issues. A resurgence of SEC enforcement against private fund advisers is likely to follow.

This chapter provides a contextual backdrop for the current enforcement landscape, highlights the key cases and examination trends, discusses emerging enforcement risks and offers practical guidance for private fund advisers who wish to assess and minimise their potential exposure to enforcement inquires.

1 Eva Ciko Carman is a managing partner, Jason E Brown is a partner, Helen Gugel is counsel and Daniel Flaherty is an associate at Ropes & Gray. Litigation and enforcement associate Will Spelder made additional contributions to this chapter.

2 See SEC Division of Examinations 2021 Examination Priorities, available at www.sec.gov/files/2021-exam-priorities.pdf.

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 identified by both domestic and international entities. For example, in November 2009, the Technical Committee of the International Organization of Securities Commissions (IOSCO) issued a 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.[3] 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.[4] In March 2012, provisions of 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 division now known as EXAMS formed a Private Funds Unit with personnel focusing on private equity firms and began examinations of private equity advisers under the Presence Exam Initiative, a direct response to the new Dodd-Frank provisions and concerns of pervasive conflicts. 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, EXAMS has acquired additional expertise by including industry experts from outside the agency on its teams.

EXAMS and the SEC more broadly identified a number of perceived deficiencies within the private equity industry and have provided guidance to assist private equity advisers in bolstering their compliance programmes. A notable early example of this guidance was the highly publicised 'Sunshine Speech' in May 2014, which made clear that the SEC was focusing, and would continue to focus, on the private equity industry.[5] Similarly, EXAMS

3 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 www.iosco.org/library/pubdocs/pdf/IOSCOPD341.pdf.

4 See Carlo V di Florio, director of the Office of Compliance Inspections and Examinations (OCIE, now known as EXAMS), 'Private Equity International's Private Fund Compliance' (3 May 2011), available at www.sec.gov/news/speech/2011/spch050311cvd.htm#P33_11226.

5 See Andrew J Bowden, director of OCIE, 'Spreading Sunshine in Private Equity' (6 May 2014), available at 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 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 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 www.sec.gov/news/speech/private-equity-enforcement.html.

recently offered an overview of frequent advisory fee and expense compliance issues it encounters, including issues of particular relevance to private equity fund advisers,[6] and shared its views on weaknesses in investment adviser compliance programmes.[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 in private. 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. Thus, in the Sunshine Speech, the SEC 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'. The SEC has long suggested that 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 or the fund, 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 certain conflicts of interest, including investment and co-investment allocation.

6 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 www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

7 See OCIE National Exam Program Risk Alert: Investment Adviser Compliance Programs (19 November 2020), available at www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf.

Of late, the SEC has signalled interest in potentially inaccurate or inadequate disclosures of emerging investment strategies, with a particular focus on strategies reflecting sustainable or 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.

The SEC's focus on the private equity industry centres on transparency and 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 matured 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 and major economic events, such as the market dislocation seen in 2020. The current enforcement landscape and emerging risk 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 interest 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 *supra*, footnote 2.

9 See *supra*, footnote 5.

10 See *supra*, footnote 5.

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 are poised to accelerate in the new political administration, including undisclosed fees and expenses, misallocation of expenses, valuation of investments and calculation of fees, inadequate disclosure of financial conflicts, and conflicted relationships with third parties.

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 in the Sunshine Speech in 2014.

For instance, in an 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 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.

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.[12] 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

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, and which EXAMS will focus on in 2021. See *supra*, footnote 2.

12 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 www.sec.gov/litigation/admin/2020/ia-5452.pdf.

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.

The SEC's view that disclosures that reference events that 'may' happen, which are, in fact, already happening, are insufficient to disclose then-existing conflicts is also apparent in the portfolio management context. In another recent settlement, the SEC alleged that, while raising investments for its second fund, an adviser failed to disclose that it would separately charge portfolio companies for services provided by an in-house operations group. The adviser later filed a Form ADV stating that, 'under specific circumstances', certain in-house professionals 'may' provide reimbursable services to portfolio companies. Still, the SEC determined that these disclosures did not fully and fairly disclose that the fund had an established practice of providing and charging for these services. As a result, the adviser agreed to a multimillion-dollar settlement including disgorgement and civil penalties.

The SEC's focus on disclosures concerning the fees and expenses of affiliated service providers seen in the case above is a hallmark of its enforcement programme. For example, the SEC also recently entered a settlement with Rialto Capital Management, where Rialto agreed to pay a penalty of US$350,000 for inaccurately characterising its fees and expenses, among other allocation issues discussed below. Rialto represented to its funds that its in-house professionals charged rates at or below those available from unaffiliated third parties, and benchmarked those rates in 2012. Rialto did not modify its disclosures, despite having not conducted a current market analysis, from 2013–2017. The SEC determined that continuing to represent such rates were commensurate to market rates in this context was misleading, leading Rialto to pay a civil penalty of US$350,000.[13]

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, Potomac Asset Management Company, Inc. (PAMCO) and its president settled allegations that PAMCO, inter alia, improperly used the fund's assets to pay PAMCO's adviser-related expenses, including compensating a member of the investment team, paying rent and other expenses including costs associated with PAMCO's regulatory obligations.[14] 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.

13 See *In re Rialto Capital Management, LLC*, Investment Advisers Act of 1940 Release No. 5558, Administrative Proceeding File No. 3-19906 (7 August 2020), available at www.sec.gov/litigation/admin/2020/ia-5558.pdf.

14 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 www.sec.gov/litigation/admin/2017/ia-4766.pdf.

Increasingly, the SEC is focusing on the specificity of disclosures relating to a fund's obligation to bear the adviser's operating expenses. For example, the SEC alleged that First Reserve Management misallocated expenses to funds without making appropriate disclosures or obtaining consent.[15] 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.[16] 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 that ultimately settled for approximately US$3 million.

The SEC also considers the effectiveness of an adviser's expenses allocation procedures to ensure compliance with its 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.

In another case against Corinthian Capital Group, its CEO and CFO, the SEC commented on Corinthian's improper allocation of organisational expenses to a fund client while alleging wide-ranging compliance failures.[17] The SEC noted that the fund's documents permit Corinthian to call capital to pay the fund's organisational expenses, but 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

15 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 www.sec.gov/litigation/admin/2016/ia-4529.pdf.

16 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 www.sec.gov/litigation/admin/2018/ia-5074.pdf.

17 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 www.sec.gov/litigation/admin/2019/ia-5229.pdf.

before the actual 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 US$140,000 in civil monetary penalties.

The SEC has also made clear that an adviser must allocate expenses shared by multiple funds or co-investors proportionately or in compliance with the governing fund documents. For instance, the SEC recently entered a settlement with Rialto Capital Management, where Rialto agreed to pay a penalty of US$350,000 for inappropriately allocating expenses for services provided by in-house employees, among other disclosure issues discussed above. Though these in-house services were provided to co-investment vehicles, Rialto charged the entirety of the expenses to two funds. Rialto fully remediated the funds but was still required to pay a civil penalty.[18]

In a similar case recently settled by Lightyear Capital, the SEC alleged that the adviser failed to allocate expenses including closing costs to co-investors and instead charged all of those expenses to the funds.[19] From 2001 to 2016, Lightyear allowed employees and certain other investors to invest alongside the funds in particular portfolio companies. Without disclosing as much to the funds' investors, the adviser charged all of the expenses from these co-investments to the funds. The SEC determined that the funds had been overcharged US$388,000 in expenses since their inception in 2000. As a result of these and other allegations, Lightyear agreed to pay US$400,000 to settle the matter.

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 monetary 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.

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

18 See *supra*, footnote 13.

19 See *In re Lightyear Capital LLC*, Investment Advisers Act of 1940 Release No. 5096, Administrative Proceeding File No. 3-18958 (26 December 2018), available at www.sec.gov/litigation/admin/2018/ia-5096.pdf.

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 that 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.

Similarly, the SEC recently entered into a settlement with EDG Management Company, LLC relating to the adviser's incorrect calculations of management fees.[22] The fund's documents required that the basis of the fee calculations be reduced upon the occurrence of certain triggering events, including the 'write-down' of portfolio investments. Though five portfolio securities were subject to write-downs between January 2016 and October 2019, the adviser failed to account for these write-downs in its fee calculations, resulting in more than US$900,000 of management fees being incorrectly charged to the fund. To settle the issue, EDG agreed to pay US$1 million in disgorgement and prejudgment interest, as well as a civil penalty of US$175,000.

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 in assets under management focused on residential mortgage-backed securities.[23] 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

20 See *Securities and Exchange Commission v. Bluepoint Investment Counsel, et al.*, Litigation Release No. 24632 (30 September 2019), available at 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 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 www.sec.gov/litigation/admin/2019/ia-5373.pdf.

22 See *In re EDG Management Company, LLC*, Investment Advisers Act of 1940 Release No. 5617, Administrative Proceeding File No. 3-20133 (22 October 2020), available at www.sec.gov/litigation/admin/2020/ia-5617.pdf.

23 See SEC Division of Enforcement 2019 Annual Report, available at: 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 www.sec.gov/litigation/admin/2019/ia-5245.pdf.

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.

This shift beyond the fee consequences of valuations to scrutiny of valuations and related policies and procedures for their own sake is becoming an increasing area of SEC scrutiny, particularly in light of recent market conditions. In the SEC's view, market dislocation has heightened the risk that private equity advisers are not fairly valuing their fund assets, which could exacerbate issues under the recently expanded advertising rule or unfairly suppress secondary markets by leading limited partners to believe their investments are more valuable than they are.

An early example of the SEC's enforcement interest in this regard was the settlement involving Icon Capital LLC.[24] Icon, an unregistered adviser to equipment leasing funds focused on commercial shipping assets, allegedly made accounting errors and materially overstated fund assets in multiple reporting periods by relying on an asset valuation model that utilised historic average lease and scrap values as inputs, while knowing then-current lease rates in a depressed commercial shipping environment in 2009–2014 were significantly different. Icon allegedly failed to timely write down its assets, did not sufficiently do so, and made related accounting errors resulting in overstatements of its funds' performance for multiple periods. To settle these allegations, Icon agreed to pay a civil money penalty of US$750,000.[25]

As the SEC considers recent economic events, and more broadly considers private fund advisers' outreach to fund clients under an expanded advertising rule, the specific bases for fund performance estimates are becoming increasingly relevant. For example, in a litigated matter that resulted in permanent injunctive relief and receivership over fund and adviser assets, the SEC recently alleged a credit fund fraudulently overstated performance by recognising loan origination fees as revenue before such fees were actually received.[26] This level of heightened scrutiny also extends to emerging asset classes, such as digital assets,[27] and practices for engaging and interacting with third parties who provide valuation or accounting services. Robust documentation and reliable processes, including those that incorporate back-testing procedures, will be increasingly important as the SEC further explores valuation issues, with a broadening view of related conflicts of interest.

24 See *In re Icon Capital LLC f/k/a Icon Capital Corporation*, Securities Exchange Act of 1934 Release No. 78030, Accounting and Auditing Enforcement Release No. 3783, Administrative Proceeding File No. 3-17283 (10 June 2016), available at https://www.sec.gov/litigation/admin/2016/34-78030.pdf.

25 id.

26 See *Securities and Exchange Commission v. TCA Fund Management Group Corp. and TCA Global Credit Fund GP Ltd.*, No. 1:20-cv-21964 (S.D. Fla. Filed 11 May 2020).

27 See The Division of Examinations Risk Alert: The Division of Examinations' Continued Focus on Digital Asset Securities (26 February 2021), available at https://www.sec.gov/files/digital-assets-risk-alert.pdf.

iv Undisclosed financial conflicts

The SEC considers undisclosed loans, investments, and other financial interests to be a potential conflict of interest. The SEC's settlement with JH Partners provides a good example.[28] 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).[29] 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.

Steven Bruce and Charter Capital Management, LLC, recently settled charges of similar issues with the SEC.[30] 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 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.

Failure to disclose financial conflicts, among other allegations such as undisclosed monitoring fees, also 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.[31] 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

28 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 www.sec.gov/litigation/admin/2015/ia-4276.pdf.

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

30 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 www.sec.gov/litigation/admin/2019/ia-5226.pdf.

31 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 www.sec.gov/litigation/admin/2019/33-10687.pdf. This matter also involved undisclosed monitoring fees.

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.

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 instructive example of an undisclosed relationship with a third party comes from a resolution with Centre Partners Management.[32] 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.

In March 2020, the SEC settled similar allegations against Naya Ventures, LLC, an unregistered venture capital adviser, and its founders, Dayakar Puskoor and Prabhakar Reddy, among other compliance failures. [33] According to the settlement order, one of Naya's fund's portfolio companies was majority-owned by the founders and provided services to other portfolio companies in exchange for compensation. Contrary to its agreements, the adviser failed to disclose to investors that the founders were affiliated with an entity providing compensated services to portfolio companies. To settle these and other allegations, the adviser was ordered to pay a civil penalty of US$40,000, and the founders were each ordered to pay civil penalties of US$20,000.

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.[34] 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

32 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 www.sec.gov/litigation/admin/2017/ia-4604.pdf.

33 See *In re Naya Ventures, LLC, Dayakar Puskoor and Prabhakar Reddy*, Investment Advisers Act of 1940 Release No. 5461, Administrative Proceeding File No. 3-19728 (12 March 2020), available at www.sec.gov/litigation/admin/2020/ia-5461.pdf.

34 See *supra*, footnote 16.

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.

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.[35] The SEC alleged that, in order 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.

The SEC has also considered undisclosed discounts received from third-party service providers to be a conflict of interest. In an early 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.

Similarly, in its settlement order with First Reserve Management, LP discussed above, 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.[36] 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, already receiving a better discount. Following an 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 discounts 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.

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

36 See *supra*, footnote 15.

IV EMERGING ENFORCEMENT RISKS

As the market has responded to the SEC's view of fiduciary principles in private equity, and considered conflicts more carefully, the SEC has moved from failures to disclose conflicts, towards assessing whether firms have acted consistently with their disclosures. In this context, private equity advisers should consider the SEC to have developed expertise assessing the conflicts inherent in the industry, and to now be scrutinising the specifics of advisers' disclosures and practices. The focus on fiduciary failures remains fixed, but the prominence of policies, procedures, and practical interactions with investors is increasing. To date, this is most apparent in material non-public information (MNPI) controls and risk management, but recent drivers have further fuelled heightened scrutiny in restructurings, and ESG investing.

i MNPI controls and risk management

The SEC has recently suggested that private equity compliance professionals are responsible for independently verifying the representations of investment team professionals where they relate to material regulatory risks. In a prominent and widely covered example, the SEC alleged that Ares Management LLC had inadequate written policies and procedures to ensure that Ares-designated directors serving on the board of a publicly traded portfolio company did not possess MNPI when Ares' funds traded their shares.[37] Ares' compliance staff allegedly relied on the director's assessments of materiality without reliable processes to verify the director's determinations, or to insulate potential MNPI from Ares' investment decisions. The SEC settlement criticised *ad hoc* utilisation of risk management procedures, such as information walls, and inadequate documentation to show compliance professionals had sufficiently independently inquired into the risk area, concluding that Ares relied too heavily on its designee-director without a reliable process to ensure against the risk that the director erred when representing that Ares had no access to potential MNPI. Notwithstanding not finding that the director misrepresented Ares' access to MNPI, the SEC settlement still required Ares pay a US$1 million penalty.

More directly, the Division of Enforcement cautioned that recent market changes resulting from the coronavirus pandemic have increased the risk of violations relating to MNPI. The dramatic economic effects of the pandemic created a context in which many corporate insiders have greater access to MNPI, and many companies' MNPI carries greater economic significance. While private equity firms generally have limited dealings with publicly traded securities, EXAMS and Enforcement have inquired into MNPI risks arising in scenarios such as take-private transactions, public offerings or block sales of portfolio company equity, or dealings with special purpose acquisition companies.

ii Restructuring risks

Recent market dislocation has accelerated the SEC's scrutiny of specific practices regarding adviser-led fund restructurings and other steps taken to address complex liquidity and valuation issues. EXAMS recently confirmed it would focus on the circumstances surrounding these transactions in its 2021 Priorities.[38] In an early example of the SEC's interest in this

37 See *In re Ares Management LLC*, Investment Adviser Act of 1940 Release No. 5510, Administrative Proceeding File No. 3-19812 (26 May 2020), available at www.sec.gov/litigation/admin/2020/ia-5510.pdf.

38 See *supra*, footnote 2, at page 30.

area, a private equity adviser and its owner agreed to a US$200,000 civil penalty to settle charges that the adviser misrepresented the value of fund limited partner positions when offering to buy out investors desiring liquidity at a price set by fund asset values that were several months stale, while in possession of preliminary information that net asset values had potentially increased. This is indicative of the SEC's interest in scrutinising the bases for valuations associated with secondary transactions and other adviser-led transactions, such as fund cross trades.

More broadly, in this context, EXAMS has inquired into specific investor communications concerning stapled agreements to commit to new funds alongside restructuring events. Other preferential treatment, fee or expense concessions, or other individualised accommodations have similarly been an area of increasing interest. In this context, advisory committee approval is playing a less significant role to deter SEC scrutiny, as the SEC searches for misrepresentations or omissions in specific investor disclosures. The increasing rate of restructuring transactions within private equity, and their complexity, has invited heightened enforcement interest to look behind the shield of sophisticated legal representation to ensure advisers are taking adequate steps to obtain informed investor consent to conflicts.

iii ESG investing

As capital deployed in other asset classes is increasingly allocated to socially responsible products, or those that actively pursue strategies rooted in environmental, social, or governance criteria, and as other jurisdictions implement comprehensive regulations on adviser-level disclosures concerning certain of these matters, the SEC has publicly announced its intention to analyse private equity and other investment advisers' disclosures on these matters in order to suss out material misrepresentations. Prominent recent examples include EXAMS stating its intention to focus on qualified opportunity funds and products offered to pursue ESG-conscious strategies,[39] and its recent issuance of an ESG Investing risk alert,[40] or the announcement of an enforcement division task force mandated to analyse disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.[41] Whether the SEC will focus only on private equity funds pursuing impact strategies, or will more broadly assess practices for, and disclosures of, considering ESG topics in risk assessments during the course of investment and portfolio management, remains to be seen. Enforcement actions to remediate and deter materially misleading overcommitments to ESG principles are, however, increasingly likely as the rush to market 'green' or 'responsible' advisory services has created a risk that advisers cannot measure up to their disclosures, or measure the details they committed to monitor. Until industry standards for ESG terms, performance and reporting emerge, enforcement interest in this field is likely to remain heightened.

39 See *supra*, footnote 2.

40 See The Division of Examinations Risk Alert: The Division of Examinations' Review of ESG Investing (9 April 2021), available at www.sec.gov/files/esg-risk-alert.pdf.

41 SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (4 March 2021), available at www.sec.gov/news/press-release/2021-42.

V KEY TAKEAWAYS AND PRACTICE TIPS

Although 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 remains focused on the possible conflicts inherent in the private equity business model, and its wider industry, and scrutinising specific instances where they arise. 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. In certain scenarios, reimbursing investors pursuant to the equitable principles governing the SEC's disgorgement decisions may also be appropriate.[42]

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 judgement. 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.

42 Notwithstanding recent legislative activity potentially broadening the SEC's disgorgement authority in civil litigation, the SEC recently suggested in a published settlement order that its administrative disgorgement authority is limited by the equitable principles set forth in *Liu v. SEC*, 140 S. Ct. 1936, (2020). See *In re Lightspeed Trading*, Securities Act of 1933 Release No. 10924, Administrative Proceeding File No. 3-20216 (2 February 2021), available at www.sec.gov/litigation/admin/2021/33-10924.pdf.

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 pursues 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. As EXAMS director Peter Driscoll recently cautioned, firms should monitor their conflict risks with robust, meaningful, and supported compliance programmes, rather than take a 'check-the-box' approach to compliance.[43]

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.[44] 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.

Particularly in contexts where advisers are leading inherently conflicted transactions, or disclosing details in a dynamically changing environment or emerging area lacking precise definitions, the details matter. Compliance teams should implement processes and have the requisite resources to independently verify financial and strategic disclosures before they become subject of SEC scrutiny.

43 See Peter Driscoll, Director of OCIE, 'The Role of the CCO – Empowered, Senior and With Authority' (19 November 2020), available at www.sec.gov/news/speech/driscoll-role-cco-2020-11-19.

44 See, e.g., *supra*, footnote 6.

VI 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.

Appendix 1

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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. Eva's litigation and regulatory work has received recognition from *Best Lawyers in America*, *The Legal 500*, *Crain's*, and *Chambers & Partners*, where clients describe her as 'extraordinarily knowledgeable', 'exceptionally smart' and 'superb at what she does'.

Eva has 30 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 dozens of 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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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 investment advisers on over 100 SEC examinations and regularly advises clients on SEC enforcement actions.

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