PRIVATE EQUITY UPDATE

Industry and Regulatory Developments

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Recent regulatory pronouncements relating to asset management firms and investment advisers have specific application to private equity. Below are highlights of certain developments from the past few months, with a focus on the implications for private equity firms and their funds and investors.

Summary of themes:

- Continued emphasis on allocation of fees and expenses, allocation of co-investment opportunities and valuations
- Very low tolerance by regulators for conflicts of interest that are not mitigated and clearly disclosed
- Increased regulatory and reporting requirements for private equity firms
- An SEC examination process that reflects more familiarity with private equity, but with the continuing possibility of enforcement actions

Fee and Expense Practices and Disclosure of Problems

The private equity industry, regulators and limited partners remain focused on various fee and expense practices, notably the allocation of expenses in the “operating partner” model (where an operating professional close to the sponsor is dedicated to a portfolio company and the services are treated as a fund or portfolio company expense); sponsor incentives, fees and savings associated with group purchasing programs across portfolio companies; advisory or monitoring fees that are accelerated and paid by portfolio companies in a lump sum upon an initial public offering or exit event; and the shifting of various expenses away from internal vehicles, “friends and family” vehicles or co-investment vehicles, to a main fund.

FUND AND REGULATORY PUBLICATIONS / NEWS

- SEC Proposes Public Disclosure Regarding Separately Managed Accounts, Changes to Adviser Registration and Enhanced Recordkeeping Around Adviser Performance
- U.S. Commerce Department Announces Filing Extension for the BE-10 Survey
- SEC Proposes Significant Changes to Reporting Requirements for Registered Investment Companies and Investment Advisers
- The Department of Labor Re-Proposes Fiduciary Rulemaking for Employee Benefit Plans and IRAs
- SEC Brings First Whistleblower Enforcement Action for Overly Restrictive Confidentiality Agreements
- U.S. Treasury International Capital Reporting Requirements for Investment Managers
- U.S. Commerce Department BE-10 Reporting for U.S. Direct Investment Abroad
- U.S. Commerce Department Reporting for Foreign Direct Investments

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With this continued focus, and a number of SEC examinations working through the system, private equity firms have been reviewing the disclosure obligations they may have to investors with respect to fee and expense problems. Press reports also indicate that some firms have received Wells Notices (stating the SEC staff's intention to recommend an enforcement action) and have communicated these matters to their limited partners. Firms need to consider their reporting obligations to limited partners – as set forth in a fund agreement or side letters – and the possibility of "inevitable disclosure" under freedom-of-information laws or open-access meetings of state pension plan investors. Firms that are part of a publicly traded platform must also review their potential public disclosure obligations generally. In the course of an SEC examination or self-assessment, firms may also consider reversing allocations to a fund that may have been viewed previously as a matter of discretion but are now subject to heightened attention, in an effort to limit potential adverse scrutiny or consequences.

Alpha Titans – Allocation of Expenses, Conflicts of Interest and Collateral Consequences

In April 2015, the SEC settled administrative proceedings against Alpha Titans, a hedge fund advisory firm, along with the firm's Chief Executive Officer and Chief Operating Officer/General Counsel. The SEC alleged that Alpha Titans improperly used fund assets to pay for its operational expenses, including employee salaries and health benefits, rent, parking, utilities, computer equipment, technology services and other operational costs. According to the SEC order, the use of fund assets to pay for these expenses created significant conflicts of interest that were not disclosed to investors.

The SEC's review of fee and expense allocations in the context of conflicts of interest – and the fiduciary obligation to eliminate conflicts, or mitigate and disclose them – is consistent with the views expressed by Julie M. Riewe, Co-Chief of the Asset Management Unit, Division of Enforcement, in remarks entitled "Conflicts, Conflicts Everywhere" made in February 2015. While the Alpha Titans case involves a hedge fund manager rather than a private equity firm, the themes around conflicts, disclosure and the consequences of improper allocations of expenses are illustrative. The SEC indicated that the allocation of adviser-related operating expenses to the funds was not "clearly" authorized by the operative documents, noting that the relevant limited partnership and operating agreements were vague and that earlier, specific PPM disclosure had been replaced with broader language that referenced operational and administrative expenses but only in a general way.

As a result, the SEC alleged that Alpha Titans' Form ADV did not adequately disclose the adviser's compensation and fees. Further, the SEC alleged that the fund financial statements, in failing to disclose the allocation of adviser-related expenses to the funds, had omitted disclosure of related party transactions and were therefore not in compliance with GAAP – and as a result, Alpha Titans had failed to meet the requirements of the "audit exception" to the Custody Rule (Rule 206(4)-2), which requires delivery of GAAP financial statements in lieu of certain reporting requirements and a surprise custody examination.

Alpha Titans agreed to disgorgement and a civil penalty, both executives agreed to a bar from the securities industry for one year and Alpha Titans agreed to an independent monitor to oversee the wind-down of the funds (which was in process prior to the SEC's order).

See In the Matter of Alpha Titans, LLC et al., SEC Release 34-74828 (April 29, 2015), available here.

Private Equity: A Look Back and a Glimpse Ahead – Speech by Marc Wyatt, Acting Director of OCIE

In May 2015, Marc Wyatt, who recently became Acting Director of the Office of Compliance, Inspections and Examinations (OCIE), presented his views on compliance themes going forward in private equity. In a speech entitled "A Look Back and a Glimpse Ahead," Wyatt reviewed OCIE's private funds initiatives and noted the staff's enhanced expertise in private equity. Following on themes from former OCIE Director Drew Bowden's "Spreading Sunshine in Private Equity" speech from a year ago, Wyatt noted some progress and improved disclosure but continuing issues regarding the allocation of fees and expenses between firms and their funds, the allocation of co-investment opportunities among investors, valuation practices, and conflicts of interest generally.

The speech also noted a recent effort to review ancillary private equity classes such as real estate, referencing in particular the vertically-integrated real estate fund model and the provision of related services by affiliates of the real estate fund manager at fees that are indicated to be below market.

Wyatt referenced the collaboration between OCIE and Enforcement and the potential time lag – up to two years or longer – between examination activity and the public announcement of an enforcement action or settlement, suggesting that the next year may bring additional private equity enforcement cases.

Significantly, Wyatt noted initiatives in the private equity industry to access retail and mass affluent investors, indicating that such investors will need full transparency into fees, conflicts and the risks inherent in the private equity model.

See Private Equity: A Look Back and a Glimpse Ahead, speech by Marc Wyatt, Acting Director, Office of Compliance, Inspections and Examinations, May 13, 2015, available here.

Whistleblower Exam and Confidentiality Issues Affect Private Equity Firms

The SEC staff is currently conducting a limited-scope examination of certain registered investment advisers regarding policies relating to whistleblower reporting, protections and confidentiality. Information is being sought from firms regarding violations of whistleblower policies, disciplinary or legal action relating to employees and actions that could be viewed as retaliatory, and any confidentiality or non-disparagement provisions that could impede an employee's ability to communicate directly with the SEC about possible securities laws violations.

This "street sweep" review follows the KBR enforcement action in April 2015. The SEC alleged that KBR, a technology and engineering firm, violated Rule 21F-17 under the Exchange Act, which prohibits any person or company from enforcing, or threatening to enforce, a confidentiality agreement that impedes an employee's ability to communicate directly with the SEC staff about a possible securities law violation. According to the SEC order, KBR employees were required to sign confidentiality agreements, in advance of interviews in an internal investigation, that prohibited the employee from discussing the interview and its subject matter without prior authorization from the KBR legal department.

In light of the KBR case and the increased emphasis on whistleblower protections, private equity firms should review their practices regarding reporting of compliance and regulatory matters and the confidentiality provisions they include in various firm

documents (such as carry agreements, employment agreements and separation agreements) – and should also consider the appropriate role of the Chief Compliance Officer in these situations.

See our client memorandum entitled SEC Brings First Whistleblower Enforcement Action for Overly Restrictive Confidentiality Agreements, *dated April 2, 2015.*

Proposed Disclosure and Recordkeeping Requirements for Private Equity Firms

In May 2015, the SEC proposed changes to disclosure and recordkeeping requirements of investment advisers, which if adopted will affect private equity firms registered under the Advisers Act in a number of significant ways.

The changes to Form ADV would elicit detailed information concerning a private equity firm's separately managed accounts, including disclosure on the use of borrowings and derivatives, and would increase information required regarding a firm's branch office operations and use of social media platforms such as Twitter, Facebook and LinkedIn. The proposals would also effectively require a registered investment adviser to disclose if it makes use of an "outsourced" Chief Compliance Officer – common for smaller private equity firms that may have limited internal resources – by requiring information on whether the CCO receives compensation or is also employed by another person or entity for compliance services.

The proposed amendments to the recordkeeping rule (Rule 204-2) would require private equity firms to maintain records underlying the calculation of performance information distributed to any person – the current rule requires that records be maintained if such information is distributed to ten or more persons. The proposals would also expand the recordkeeping requirements for communications related to performance of managed accounts and securities recommendations.

The Form ADV and recordkeeping proposals were overshadowed by proposals on the same day that would significantly increase the reporting requirements for registered investment companies – but private equity firms should be reviewing their operational, disclosure and record-retention practices in light of these proposed amendments relating to registered investment advisers.

See our client memoranda entitled SEC Proposes Public Disclosure Regarding Separately Managed Accounts, Changes to Adviser Registration and Enhanced Recordkeeping Around Adviser Performance, *dated June 5, 2015, and* SEC Proposes Significant Changes to Reporting Requirements for Registered Investment Companies and Investment Advisers, *dated May 21, 2015.*

Cybersecurity Guidance – Risks and Reputational Issues for Private Equity Firms

In April 2015, the Division of Investment Management issued guidance on cybersecurity risks, noting cyber-attacks on a wide range of financial services firms. The guidance provides a number of measures that investment advisers may wish to consider:

- conducting a periodic assessment of information maintained, threats and vulnerabilities, existing controls and processes, the impact an incident might have and the governance structure for management of cybersecurity risks;
- creating a strategy designed to prevent, detect and respond to cybersecurity threats; and

- implementing written policies and procedures, training and monitoring.

The staff notes, in particular, a strategy including controlled access to systems and data, use of encryption and monitoring software, data backup and retrieval and the development of an incident response plan, as well as diligence of cybersecurity protections at third-party service providers. The guidance follows the 2014 sweep examination by the OCIE staff of 57 registered broker-dealers and 49 registered investment advisers, to assess vulnerability to cyber-attacks.

Private equity firms may view cybersecurity issues as less relevant to their business, as they typically have more limited personal information and transaction processing demands than broker-dealers or retail investment managers. However, private equity managers should not be complacent about cyber-related risks, both to fund assets and to a firm's reputation. Limited partners have recognized the importance of this issue and are increasingly conducting diligence on cybersecurity in the course of the private equity fundraising process.

See IM Guidance Update: Cybersecurity Guidance, Division of Investment Management, U.S. Securities and Exchange Commission, April 2015, available here.

DOL Fiduciary Proposals Would Limit Retail Retirement Plan Access to Private Equity Funds

In April 2015, the Department of Labor proposed regulations that would significantly expand who is a "fiduciary" under ERISA and the Internal Revenue Code by virtue of providing investment advice to an employee benefit plan or IRA. Under the proposed regulations, a private equity firm's general marketing activities or sales pitch could give rise to fiduciary status. As a result, a significant effect of the proposals is that small ERISA plans and IRA investors may be completely restricted from investing in private equity funds.

The DOL has proposed certain relief from the expanded scope of the new definition. However, such relief would not apply to retail retirement plan investors' investments in private equity funds. The proposed "Seller's Exception" applies only to large ERISA plans – those that have 100 or more participants or whose plan fiduciary has at least $100 million of ERISA plan assets under management. The proposed "Best Interest Contract Exemption" is available to retail retirement plan investors; however, the exemption is limited to investments in assets deemed sufficiently liquid by the DOL and "commonly purchased by plans, participant and beneficiary accounts and IRAs," which do not include private equity funds. Further, compliance with the exemption would require such significant changes to the way private equity firms engage with investors and receive compensation that it may be impracticable for them to comply (even if the exemption was expanded to include investment in private equity funds).

The DOL's approach presumes that all retail retirement plan investors operate with the same level of financial sophistication, requiring the protections afforded under the proposed regulations, when in fact a substantial number of small plans and high net worth individual investors may benefit more from the ability to invest their retirement funds in private equity funds. It remains to be seen whether the proposals will be revised to allow the Seller's Exception to apply to sophisticated retail retirement plan investors, for example, by applying the "Qualified Purchaser" standard under the Investment Company Act of 1940.

See our client memorandum entitled The Department of Labor Re-Proposes Fiduciary Rulemaking for Employee Benefit Plans and IRAs*, dated May 8, 2015.*

Commerce and Treasury Department Reporting for International Investment Activity

Private equity firms should be aware of the reporting regimes under the Bureau of Economic Analysis (BEA – Department of Commerce) and Treasury International Capital (TIC – Department of Treasury) requirements. The BEA filings generally address international investment activity and the TIC filings generally require reporting of significant cross-border cash flows and positions between U.S. and non-U.S. persons and entities. These reporting requirements can apply to private equity firms and their funds in non-obvious ways, however, including with respect to offshore funds and transaction structuring and interactions with non-U.S. limited partners.

The BEA recently reinstated its BE-13, Survey of New Foreign Direct Investment in the United States, and is currently conducting its quinquennial (every five years) Benchmark Survey of U.S. Direct Investment Abroad, on BE-10. The BEA recently extended the BE-10 deadline, for first time filers, to June 30, 2015 and has provided guidance on its website for private funds. The various TIC forms are also periodically revised or adjusted as to filing requirements and thresholds.

See our client memoranda entitled U.S. Commerce Department Announces Filing Extension for the BE-10 Survey*, dated May 29, 2015,* U.S. Commerce Department BE-10 Reporting for U.S. Direct Investment Abroad*, dated February 18, 2015,* U.S. Commerce Department Reporting for Foreign Direct Investments*, dated February 4, 2015, and* U.S. Treasury International Capital Reporting Requirements for Investment Managers*, dated March 9, 2015.*

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This Private Equity Update is distributed periodically, based on developments in the private equity industry and investment, regulatory and compliance items of interest.

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