CLIENT MEMORANDUM

Continuing SEC Focus on Private Equity Conflicts and Disclosure

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In a recent enforcement action, the Securities and Exchange Commission (the "SEC") again demonstrated its continuing focus on private equity conflicts of interest and disclosure. In the order dated November 23, 2015, the SEC alleged that JH Partners, LLC ("JHP"), a California-based manager of three private equity funds, failed to adequately disclose potential conflicts arising from insider loans and a cross-fund investment, and also permitted violations of fund concentration limits.[1]

The order indicates that from 2006 to 2012, JHP and certain of its principals loaned approximately $62 million to portfolio companies "to provide interim financing for working capital or other urgent cash needs." While the loans may have been well-intentioned, the order states that JHP and its principals in certain cases obtained interests in the portfolio companies that were senior to the equity interests held by the JHP funds. The SEC indicates that in most cases, JHP failed to disclose to the fund advisory boards either the existence of the loans or the potential conflicts of interest they created.

In addition, the SEC alleged that from 2007 to 2012, JHP caused more than one fund to invest in the same portfolio company at different priority levels and/or valuations, potentially favoring one fund over another. The SEC order indicates

[1] JHP neither admitted nor denied the SEC's findings. *See* Advisers Act Release No. 4,276, *available* here.

that JHP did not adequately disclose the potential conflicts to the fund advisory boards or seek advisory board consent for the cross-fund investments.

The order also notes that JHP funds exceeded concentration limits in the fund limited partnership agreements regarding any single investment, without adequate disclosure or written consent of the fund advisory board or limited partners.

According to the SEC order, JHP violated Section 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act"), which prohibits an investment adviser from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client" and also violated Section 206(4) of, and Rule 206(4)-8 under, the Advisers Act, which prohibit any fraudulent, deceptive or manipulative act, practice, or course of business by an investment adviser to an investor or prospective investor in a pooled investment vehicle.

It should be noted that the order relates to conduct occurring prior to JHP's registration under the Advisers Act in March 2012. Following an SEC examination, JHP in early 2013 disclosed the various transactions to the fund advisory boards, agreed to subordinate (or place on equal footing) the insider loans relative to the equity interests held by the funds, agreed to forego rights under security agreements relating to the loans, and also waived certain management fees and carried interest – and the fund advisory boards retroactively consented to the transactions. In connection with the SEC settlement, JHP agreed to pay a $225,000 fine.

Private equity managers are often faced with interim financing needs at portfolio companies, as well as potential cross-fund investments given varying investment periods and fund terms and the need for portfolio balance across multiple funds. This case emphasizes the importance of disclosure to limited partner advisory committees and, where applicable, advance LPAC approval of investments (especially firm and insider transactions) that may result in potential conflicts, different priorities or positions in a portfolio company's capital structure, different valuations for respective investments and cross-fund investments generally – consistent with the SEC's continuing regulatory focus on private equity and a view that there is no exception to the requirement of disclosing conflicts of interest.[2]

[2] See "Conflicts, Conflicts Everywhere," speech by Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, February 26, 2015: "There is, therefore, no exception to disclosure: no "well-meaning or good-faith adviser" exception for an adviser that legitimately believes it is putting its clients' interests first notwithstanding any conflicts; no "mitigation" exception for an adviser that believes it has taken adequate internal measures to account for potentially incompatible interests; and no "potential conflict" exception for an adviser that did not act upon the conflict to enrich itself at the expense of its clients."

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