

THE
SECURITIES
LITIGATION
REVIEW

THIRD EDITION

Editor
William Savitt

THE LAWREVIEWS

THE SECURITIES LITIGATION REVIEW

The Securities Litigation Review

Reproduced with permission from Law Business Research Ltd.

This article was first published in The Securities Litigation Review, - Edition 3
(published in June 2017 – editor William Savitt)

For further information please email

Nick.Barette@thelawreviews.co.uk

THE
SECURITIES
LITIGATION
REVIEW

THIRD EDITION

Editor
William Savitt

THE LAWREVIEWS

PUBLISHER
Gideon Robertson

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGERS
Thomas Lee, Joel Woods

ACCOUNT MANAGERS
Pere Aspinall, Jack Bagnall,
Sophie Emberson, Laura Lynas

MARKETING AND READERSHIP COORDINATOR
Rebecca Mogridge

RESEARCHER
Arthur Hunter

EDITORIAL COORDINATOR
Gavin Jordan

HEAD OF PRODUCTION
Adam Myers

PRODUCTION EDITOR
Robbie Kelly

SUBEDITOR
Janina Godowska

CHIEF EXECUTIVE OFFICER
Paul Howarth

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
© 2017 Law Business Research Ltd
www.TheLawReviews.co.uk

No photocopying; copyright licences do not apply.

The information provided in this publication is general and may not apply in a specific situation, nor does it necessarily represent the views of authors' firms or their clients. Legal advice should always be sought before taking any legal action based on the information provided. The publishers accept no responsibility for any acts or omissions contained herein. Although the information provided is accurate as of June 2017, be advised that this is a developing area.

Enquiries concerning reproduction should be sent to Law Business Research, at the address above.

Enquiries concerning editorial content should be directed
to the Publisher – gideon.roberton@lbresearch.com

ISBN 978-1-910813-64-5

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

THE LAW REVIEWS

THE MERGERS AND ACQUISITIONS REVIEW

THE RESTRUCTURING REVIEW

THE PRIVATE COMPETITION ENFORCEMENT REVIEW

THE DISPUTE RESOLUTION REVIEW

THE EMPLOYMENT LAW REVIEW

THE PUBLIC COMPETITION ENFORCEMENT REVIEW

THE BANKING REGULATION REVIEW

THE INTERNATIONAL ARBITRATION REVIEW

THE MERGER CONTROL REVIEW

THE TECHNOLOGY, MEDIA AND
TELECOMMUNICATIONS REVIEW

THE INWARD INVESTMENT AND
INTERNATIONAL TAXATION REVIEW

THE CORPORATE GOVERNANCE REVIEW

THE CORPORATE IMMIGRATION REVIEW

THE INTERNATIONAL INVESTIGATIONS REVIEW

THE PROJECTS AND CONSTRUCTION REVIEW

THE INTERNATIONAL CAPITAL MARKETS REVIEW

THE REAL ESTATE LAW REVIEW

THE PRIVATE EQUITY REVIEW

THE ENERGY REGULATION AND MARKETS REVIEW

THE INTELLECTUAL PROPERTY REVIEW

THE ASSET MANAGEMENT REVIEW

THE PRIVATE WEALTH AND PRIVATE CLIENT REVIEW

THE MINING LAW REVIEW

THE EXECUTIVE REMUNERATION REVIEW

THE ANTI-BRIBERY AND ANTI-CORRUPTION REVIEW

THE CARTELS AND LENIENCY REVIEW

THE TAX DISPUTES AND LITIGATION REVIEW
THE LIFE SCIENCES LAW REVIEW
THE INSURANCE AND REINSURANCE LAW REVIEW
THE GOVERNMENT PROCUREMENT REVIEW
THE DOMINANCE AND MONOPOLIES REVIEW
THE AVIATION LAW REVIEW
THE FOREIGN INVESTMENT REGULATION REVIEW
THE ASSET TRACING AND RECOVERY REVIEW
THE INSOLVENCY REVIEW
THE OIL AND GAS LAW REVIEW
THE FRANCHISE LAW REVIEW
THE PRODUCT REGULATION AND LIABILITY REVIEW
THE SHIPPING LAW REVIEW
THE ACQUISITION AND LEVERAGED FINANCE REVIEW
THE PRIVACY, DATA PROTECTION AND CYBERSECURITY LAW REVIEW
THE PUBLIC-PRIVATE PARTNERSHIP LAW REVIEW
THE TRANSPORT FINANCE LAW REVIEW
THE SECURITIES LITIGATION REVIEW
THE LENDING AND SECURED FINANCE REVIEW
THE INTERNATIONAL TRADE LAW REVIEW
THE SPORTS LAW REVIEW
THE INVESTMENT TREATY ARBITRATION REVIEW
THE GAMBLING LAW REVIEW
THE INTELLECTUAL PROPERTY AND ANTITRUST REVIEW
THE REAL ESTATE M&A AND PRIVATE EQUITY REVIEW
THE SHAREHOLDER RIGHTS AND ACTIVISM REVIEW
THE ISLAMIC FINANCE AND MARKETS LAW REVIEW
THE ENVIRONMENT AND CLIMATE CHANGE LAW REVIEW
THE CONSUMER FINANCE LAW REVIEW
THE INITIAL PUBLIC OFFERINGS REVIEW

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

BAE, KIM & LEE LLC

BÄR & KARRER LTD

CMS, RUSSIA

DARROIS VILLEY MAILLOT BROCHIER

DE BRAUW BLACKSTONE WESTBROEK NV

HANNES SNELLMAN ATTORNEYS LTD

HERBERT SMITH FREEHILLS

JINGTIAN & GONGCHENG

LINDENPARTNERS PARTNERSCHAFT VON RECHTSANWÄLTEN MBB

LOYENS & LOEFF

MAYER BROWN JSM

MORI HAMADA & MATSUMOTO

OSLER, HOSKIN & HARCOURT LLP

ROPES & GRAY

TADMOR & CO YUVAL LEVY & CO

TRINDADE SOCIEDADE DE ADVOGADOS

UGHI E NUNZIANTE STUDIO LEGALE

URÍA MENÉNDEZ

WACHTELL, LIPTON, ROSEN & KATZ

CONTENTS

PREFACE.....	v
<i>William Savitt</i>	
Chapter 1 SEC ENFORCEMENT AGAINST PRIVATE EQUITY: A PRACTICAL GUIDE FOR PRIVATE FUNDS	1
<i>Eva Ciko Carman, Jason E Brown and Kirsten Boreen Liedl</i>	
Chapter 2 AUSTRALIA.....	10
<i>Luke Hastings and Andrew Eastwood</i>	
Chapter 3 BELGIUM	32
<i>Grégoire Jakhian and Mathias Lamberty</i>	
Chapter 4 BRAZIL.....	50
<i>Marcelo Trindade and Fabiana Martins de Almeida</i>	
Chapter 5 CANADA.....	63
<i>Mark A Gelowitz, Allan D Coleman and Robert Carson</i>	
Chapter 6 CHINA.....	76
<i>Peng Xuejun, Sun Shiqi, Hu Ke and Liu Siyuan</i>	
Chapter 7 ENGLAND & WALES.....	91
<i>Karen Anderson and Harry Edwards</i>	
Chapter 8 FRANCE.....	112
<i>Bertrand Cardi and Nicolas Mennesson</i>	
Chapter 9 GERMANY.....	123
<i>Lars Röh and Martin Beckmann</i>	
Chapter 10 HONG KONG	139
<i>Thomas So and Wilson Fung</i>	

Contents

Chapter 11	ISRAEL.....	151
	<i>Yecheiel Kasber, Itai Paldor and Amir Scharf</i>	
Chapter 12	ITALY.....	160
	<i>Giuseppe De Falco and Luigi Cascone</i>	
Chapter 13	JAPAN.....	172
	<i>Mugi Sekido, Shinichiro Yokota and Shiho Ono and Yuko Kanamaru</i>	
Chapter 14	KOREA.....	180
	<i>Tony Dongwook Kang</i>	
Chapter 15	NETHERLANDS.....	193
	<i>Jan de Bie Leuveling Tjeenk and Dennis Horeman</i>	
Chapter 16	PORTUGAL.....	204
	<i>Nuno Salazar Casanova and Nair Mauricio Cordas</i>	
Chapter 17	RUSSIA.....	215
	<i>Sergey Yuryev</i>	
Chapter 18	SPAIN.....	225
	<i>Cristian Gual Grau and Manuel Álvarez Feijoo</i>	
Chapter 19	SWEDEN.....	237
	<i>David Acebo, Björn Kristiansson and Jacob Frank</i>	
Chapter 20	SWITZERLAND.....	252
	<i>Matthew T Reiter and Thomas U Reutter</i>	
Chapter 21	UNITED STATES.....	267
	<i>William Savitt and Noah B Yavitz</i>	
Appendix 1	ABOUT THE AUTHORS.....	291
Appendix 2	CONTRIBUTING LAW FIRMS' CONTACT DETAILS.....	307

PREFACE

This third 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 like China, where private securities litigation is complex, expensive, seldom remunerative and accordingly quite rare. As the survey reveals, there are many intermediate points in this continuum, as each jurisdiction has evolved a private enforcement regime reflecting its underlying civil litigation system, as well as the imperatives of its securities markets.

This review reveals an equally broad variety of public enforcement regimes. Canada’s highly decentralised system of provincial regulation contrasts with Brazil’s Securities Commission, a powerful centralised regulator that is primarily responsible for creating and enforcing Brazil’s securities rules. Every country has its own idiosyncratic mixture of securities lawmaking institutions; each provides a role for self-regulating bodies and stock exchanges but no two systems are alike. And while the European regulatory schemes have worked to harmonise national rules with Europe-wide directives – an effort now challenged by the imminent 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 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, 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 has reported an across-the-board uptick in securities litigation activity. 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 the 2008 crisis has given rise to a new normal in the private enforcement of securities laws. While class actions are a predominant feature of US securities litigation, there are signs that aggregated damages claims are making significant inroads elsewhere. Class claims are now well established as part of the regulatory landscape in Australia and Canada, and there appears to be accelerating interest around the world in securities class actions and other forms of economically significant private securities litigation. Whether and where this trend takes hold will be one of the important securities law developments to watch in coming years.

This suggests the final ambition for *The Securities Law Review*: to annually reflect 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 divergence and convergence and divergence, continuity and change – with divergence and change particularly predominant this year, following political upheaval in the United States and Britain that could herald 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 third edition. For the editor, reviewing these chapters has been a fascinating tour of the securities litigation world, and we hope it will prove to be the same for our readers. Contact information for our contributors is included in Appendix 2. We welcome comments, suggestions and questions, both to create a community of interested practitioners and to ensure that each edition improves on the last.

William Savitt

Wachtell, Lipton, Rosen & Katz

New York

June 2017

SEC ENFORCEMENT AGAINST PRIVATE EQUITY: A PRACTICAL GUIDE FOR PRIVATE FUNDS

*Eva Ciko Carman, Jason E Brown and Kirsten Boreen Liedl*¹

I INTRODUCTION

In recent years, the Securities and Exchange Commission (SEC) has brought a variety of highly publicised enforcement actions against private equity firms. By virtue of the long-tail nature of private equity investments, the cases focus on conflicts arising years after the original investment. Accordingly, these cases were not charged as standard fraud-in-the-sale cases but, rather, were pursued as cases sounding in breach of fiduciary duty. The focus on these cases led to a host of settlements that shed light on the SEC's current perspective on pursuing private funds and on the development of breach of fiduciary duty principles. These principles are relevant across the spectrum of private funds, including real estate, debt and hedge funds. This article provides a contextual back drop for these cases, highlights the key cases and examination trends, and offers practical guidance for private fund advisers who wish to assess and remediate their potential vulnerabilities to similar claims.

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

i SEC enforcement and examinations in private equity industry

Before 2010, with a few exceptions, private equity fund advisers generally did not register with the SEC and, while still subject to the securities laws, largely operated outside the SEC's regulatory regime. Nonetheless, issues within the private equity industry were beginning to be identified by both domestic and international entities. For example, in May 2008, the Technical Committee of the International Organization of Securities Commissions (IOSCO) issued a report setting forth perceived regulatory risks in the private equity industry, including increasing leverage, market abuse, conflicts of interest management, transparency, overall market efficiency, diverse ownership of economic exposure and market access.² In November 2009, IOSCO issued a subsequent report focusing on conflicts of interest within

1 Eva Ciko Carman and Jason E Brown are partners and Kirsten Boreen Liedl is an associate at Ropes & Gray.

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

the private equity industry, including the use of third-party advisers, lack of disclosure, and calculation of fees.³ In May 2011, the SEC cited IOSCO's November 2009 report as a useful public source describing conflicts of interest that private fund advisers may face.⁴

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

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

Through examinations, OCIE and the SEC more broadly have identified a number of perceived deficiencies within the private equity industry, and have begun providing guidance to assist private equity advisers in bolstering their compliance programmes. A notable example of this guidance was the highly publicised 'Sunshine Speech' by Andrew Bowden, then of OCIE, in May 2014, which made clear that the SEC was focusing, and would continue to focus, on the private equity industry.⁵

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

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.

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

5 See Andrew Bowden, director of Office of Compliance Inspections and Examinations, 'Spreading Sunshine in Private Equity' at the Private Equity International Private Fund Compliance Forum (6 May 2014), available at <https://www.sec.gov/news/speech/2014--spch05062014ab.html>; see also Julie M Riewe, co-chief of Asset Management Division, 'Conflicts, Conflicts Everywhere' at the IA Watch 17th Annual IA Compliance Conference (16 February 2015), available at <https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html>; Marc Wyatt, acting director of Office of Compliance Inspections and Examinations at Private Equity International Conference (13 May 2015), available at <https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html>; Andrew Ceresney, director of Division of Enforcement, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (12 May 2016), available at <https://www.sec.gov/news/speech/private-equity-enforcement.html>.

wield significant influence over companies in which their clients invest, and when they do, the adviser's control is generally visible to its investors and the public. In contrast, the private equity model allows a private equity adviser to use client funds to obtain a controlling interest in a non-publicly traded company, thereby obtaining significant influence over that company. Private equity advisers frequently are very involved in managing investments, such as serving on the company's board, selecting and monitoring the management team, acting as sounding boards for CEOs, and sometimes assuming management roles. In the Sunshine Speech, Andrew Bowden explained that: '[T]he private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services [. . .] or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company [. . .] or to instruct the company to add to its payroll all of the adviser's employees who manage the investment'. Bowden noted that in his view this model results in conflicts beyond those faced by typical investment advisers.

Another common theme relates to disclosure. Cases and speeches suggest that for an adviser to satisfy its fiduciary duty under Section 206 of the Advisers Act, the adviser must disclose all material information at the time investors commit their capital, including potential conflicts of interest. In the SEC's view, limited partnership agreements often contain insufficient disclosure regarding fees and expenses that could be charged to portfolio companies, as well as allocation of these fees and expenses. The SEC has also indicated that private equity advisers have often used consultants, or 'operating partners', who provided consulting services to portfolio companies and were paid directly by portfolio companies or the funds without sufficient disclosure to investors. There have also been alleged instances of poorly defined valuation procedures, investment strategies and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation. The SEC has suggested that the private equity industry has suffered from an overall lack of transparency. In the SEC's view, some limited partnership agreements do not provide investors with sufficient information to be able to monitor their investments and the investments of their adviser. Although investors engage in substantial due diligence prior to investing in a fund, because of the unique nature of the private equity model, there has rarely been meaningful investor oversight after closing. This limited oversight has the potential to increase the inherent temptations and risks already present within the private equity model.

Finally, much of the SEC's focus in the private equity industry has been on conflicts of interest. In a February 2015 speech,⁶ Julie M Riewe (then co-chief of the Asset Management Unit) stated 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 Riewe, 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

⁶ See Julie M Riewe, co-chief of Asset Management Division, 'Conflicts, Conflicts Everywhere' at the IA Watch 17th Annual IA Compliance Conference (16 February 2015), available at <https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html>.

that an investor be harmed by the conflict, or that the adviser intended to cause harm to the investor. It only requires the possibility that an investment adviser's interests could run counter to those of its investors.

As a result of the SEC's highly publicised focus on the private equity industry, investment advisers have been reviewing and changing their practices. However, the SEC's enforcement efforts and focus on the private equity industry have continued. In May 2016, Andrew Ceresney (then director of the Division of Enforcement) categorised the SEC's continued enforcement efforts in three groups: (1) advisers that receive undisclosed fees and expenses; (2) advisers that impermissibly shift and misallocate expenses; and (3) advisers that fail to adequately disclose conflicts of interest.⁷

These areas of enforcement are relevant to not only the private equity industry, but also other types of investment advisers, who are evaluating their practices and procedures, real estate, debt and hedge funds. While conflicts of interest have not been front and centre in hedge fund exams historically, examiners are beginning to ask conflict-focused questions. 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.

III CONFLICTS OF INTEREST

The SEC's interest in the private equity industry encompasses a wide range of topics, from the highly publicised accelerated monitoring fee issue to the lesser-known conflicts-of-interest issues brought up in examinations. Private equity advisers should be aware of significant areas of enforcement that have increasingly been a subject of SEC focus over the past few years, including undisclosed fees and expenses, misallocation of expenses, inadequate disclosure of investments or loans, relationships with third-party service providers and discounts received from service providers. While the SEC's enforcement actions cover just a few of the potential conflicts of interest,⁸ these actions provide good examples of SEC enforcement's approach to conflicts and the evolution of obligations arising from Section 206 of the Advisers Act. Notably, under Section 206, the SEC focuses not only on identification of conflicts, but also on the policies and procedures in place for identifying and mitigating such conflicts.

i Undisclosed fees and expenses

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

For instance, in a recent 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

7 See Andrew Ceresney, Director of Division of Enforcement, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (12 May 2016), available at <https://www.sec.gov/news/speech/private-equity-enforcement.html>.

8 For example, while no enforcement actions have been brought in the private equity space on allocations of investment and co-investment opportunities, stapled secondary transactions and valuations, these all raise potential conflicts on which the SEC has focused during exams.

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.

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 benefitted 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.

The SEC has found that an adviser is not permitted to allocate its own operating expenses to funds or portfolio companies if this practice has not been disclosed to investors. For example, in the SEC's settlement with Cherokee Investment Partners and Cherokee Advisers (together, Cherokee),⁹ the SEC alleged that Cherokee allocated to its funds US\$455,698 in consulting, legal and compliance-related expenses incurred in the course of registering as an investment adviser. Cherokee did not disclose to investors that funds would be charged for the adviser's legal and compliance expenses. Cherokee ceased this practice in March 2015 and reimbursed the funds for these expenses in April 2015. Nonetheless, because Cherokee had failed to disclose this practice to investors, Cherokee ultimately paid a US\$100,000 civil money penalty to settle this matter.

The SEC also alleged that First Reserve Management misallocated expenses to funds without making appropriate closures or obtaining consent.¹⁰ 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 reimburse the funds and revise its practices and disclosures, and agreed to pay a civil money penalty of US\$3.5 million.

Finally, the SEC has also made clear that an adviser must allocate expenses shared by multiple funds proportionately or in compliance with the governing fund documents. For

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

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

instance, the SEC charged Lincolnshire Management for misallocating expenses between two portfolio companies.¹¹ Lincolnshire had merged two portfolio companies and managed them as one company, although the two portfolio companies remained distinct legal entities that were owned by two separate funds. However, the SEC alleged that Lincolnshire allocated a disproportionate share of the companies' joint expenses to one portfolio company, to the detriment of that portfolio company's fund's investors. For example, it claimed one portfolio company paid for third-party administrators to provide payroll services, but both portfolio companies used these services. Similarly, it stated that certain employees did work that benefitted both companies, but their salaries were not allocated between the two companies. Lincolnshire agreed to pay US\$1.5 million in disgorgement and prejudgment interest, as well as a civil money penalty of US\$450,000, to resolve these allegations.

iii Undisclosed loans and investments

The SEC considers undisclosed loans and investments, as well as misallocation of investment opportunities, to be a potential conflict of interest. The SEC's settlement with JH Partners provides a good example.¹² In that matter, the SEC alleged that JH Partners and certain of its principals provided a loan to the funds' portfolio companies, thereby obtaining interests in portfolio companies that were senior to the equity interests held by the funds. JH Partners 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 money penalty of US\$225,000.

iv Undisclosed relationships with third parties

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

One recent example of an undisclosed relationship with a third party comes from a resolution with Centre Partners Management.¹³ 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

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

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

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

occupied seats on the service provider's board of directors, 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 money penalty of US\$50,000.

v Undisclosed discounts from service providers

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

For example, in its settlement order with First Reserve (discussed earlier), the SEC alleged, *inter alia*, that First Reserve arranged for a law firm to provide legal services to both First Reserve and its funds from approximately 2010 to 2014.¹⁴ 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 a law firm for itself that was based on the large volume of work the law firm performed for the funds. First Reserve did not negotiate a similar discount for the funds. Beginning in early 2013, First Reserve began disclosing in its Form ADV that it could receive service provider discounts that might be more favourable than those received by the funds, but did not disclose that it was in fact receiving that discount. The SEC 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. Following the OCIE examination, First Reserve agreed to pay to the funds its *pro rata* share of the discount First Reserve received from the law firm, and provided investors with information regarding its planned practices going forward. To settle these allegations, among others, First Reserve agreed to pay a civil money penalty of US\$3.5 million.

In another similar example of an undisclosed service provider, 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.

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

IV KEY TAKEAWAYS AND PRACTICE TIPS

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.

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.

iii Focus on both actual and potential conflicts

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

iv Disclosures in pre-commitment documents

The SEC has emphasised 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. As Andrew Ceresney explained in his May 2016 speech, private equity advisers have always been investment advisers subject to the Advisers Act, and were therefore fiduciaries subject to the Advisers Act anti-fraud provisions. 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.

vi Questionnaires

In light of the importance of fees paid to affiliates, advisers should consider regularly sending questionnaires to their personnel regarding any outside business contacts or interests. Any responses should be checked against the adviser's own relationships, as well as those of service providers, portfolio companies, and entities that have relationships with portfolio companies.

V CONCLUSION

The SEC's pursuit of cases in the private equity context has not only shed light on the type of conduct that the SEC views as most problematic, it has also provided invaluable insight into 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.

ROPES & GRAY

1211 Avenue of the Americas
New York, NY 10036-8704
United States
Tel +1 212 596 9000
Fax +1 212 596 9090
eva.carman@ropesgray.com

Prudential Tower
800 Boylston Street
Boston, MA 02199-3600
United States
Tel +1 617 951 7000
Fax +1 617 951 7050
jebrown@ropesgray.com
kirsten.liedl@ropesgray.com

www.ropesgray.com

EVA CIKO CARMAN

Ropes & Gray

Eva Carman is co-head of Ropes & Gray's Securities and futures enforcement group and the co-managing partner of the firm's New York office. Her securities enforcement work has received national recognition from *The Legal 500* and *Chambers & Partners*, where clients describe her as 'superb at what she does'. In addition, her work led to the firm receiving an award from the *Financial Times* in connection with an innovative approach to pre-regulatory examination counselling that she co-designed. In total, she has over 25 years of experience representing investment advisers in connection with SEC examinations, investigations and litigated actions. Her recent experience includes involvement in over 30 PE, real estate exams and hedge fund exams, and acting as lead defence counsel on a number of key adviser enforcement actions. The breadth of this experience gives her a unique first-hand insight into the SEC's focus and approach. This experience combined with her deep understanding of the business enables her to give her clients practical guidance on how best to achieve the goal of a brief and benign exam or a successful resolution or trial of an enforcement action. Her practice is nationwide, having handled recent cases in seven of the SEC's offices. While most of her successes are non-public, they include garnering a rare pre-Wells termination of a fees and expenses investigation, and successful resolution of a multi-year PE investigation. This experience along with knowledge of the regulators, sensitivity to the nuances of working in a politically charged atmosphere, and a deep understanding of her clients' industry and businesses, make her a sought-after counsellor, advocate and speaker.

JASON E BROWN

Ropes & Gray

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

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

Jason has worked with over 40 investment advisers on SEC examinations and regularly advise clients on SEC enforcement actions.

He has also advised a wide variety of registered investment advisers on Advisers Act and other regulatory matters as new funds or products are launched, compliance questions arise or new rules are adopted.

KIRSTEN BOREEN LIEDL

Ropes & Gray

Kirsten Boreen Liedl is an associate in the government enforcement practice group. Kirsten has diverse experience in government-initiated and internal investigations. Her experience includes representing clients in matters involving the False Claims Act, federal and state anti-kickback laws, and federal securities laws.

Kirsten maintains an active pro bono immigration practice, specifically focusing on the representation of children. Kirsten has also represented individuals in family law matters and an incarcerated individual seeking exoneration through DNA testing.

Prior to joining the firm, Kirsten served as a judicial clerk to Justice Peter T Zarella at the Connecticut Supreme Court. During law school, Kirsten was a comments editor for the *University of Pennsylvania Law Review* and an Arthur Littleton and H Clayton Louderback Legal Writing Instructor.