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Stephanie R. Breslow, Ch. 12: Investment Advisers Act of 1940 (2nd Edition) (November 2016)

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Schulte Roth & Zabel LLP

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Chapter 12

Investment Advisers Act of 1940

Delivery of an adviser's Form ADV Part 2 brochure can be made in paper and, in certain circumstances, electronically where advisory clients have notice that the Form ADV Part 2 brochure is available in electronic form, advisory clients have access to an electronically delivered Form ADV Part 2 brochure and the adviser can evidence delivery of its brochure either through informed client consent or actual client receipt of the brochure.

Even if an adviser is not required to register as an investment adviser with a state, many states may nonetheless impose certain requirements. Many states require SEC-registered advisers to provide them with basic information about their business, which can generally be accomplished by making a "notice filing" with such states by providing the states with the Form ADV filed with the SEC and making payment of designated filing fees.[15] Depending on the laws of a given state, an adviser may be required to make a notice filing in a state where the adviser has a principal place of business and/or where it has more than a *de minimis* number of clients. Additionally, states where an adviser has "investment adviser representatives," which are generally advisory employees who solicit and provide advisory services to a minimum number and percentage of natural person clients within a state, may require the investment adviser representatives to register with the state and/or take certain qualification examinations. The determination of which advisory personnel constitute "investment adviser representatives" will vary depending on the definition of an "investment adviser representative" included in a particular state's securities laws. As a practical matter, however, most private equity fund advisers will not be required to register their advisory personnel with most states unless the adviser solicits a certain number of "natural person" clients that are not "qualified clients." Sponsors of most private equity funds therefore do not face this issue.

If an adviser either no longer provides advisory services or is otherwise eligible to withdraw its SEC registration and chooses to do so, it can file Form ADV-W with the SEC through the IARD, and withdrawal will generally become effective immediately.

§ 12:2.4 Consequences of Investment Advisers Act Registration

A number of consequences flow from Advisers Act registration.

15. Delivering Form ADV to states can be easily accomplished through "checking the box" on the front of Form ADV indicating states to where Form ADV should be delivered and by paying appropriate state filing fees.

[A] Required Policies and Procedures

Rule 206(4)-7[16] of the Advisers Act requires registered advisers to adopt and maintain policies and procedures reasonably designed to detect and prevent violations of the Advisers Act and the other securities laws. The adopting release for Rule 206(4)-7 delineates certain policies and procedures that a registered adviser should establish and maintain, and these policies and procedures are discussed in detail in section 12:5.7 and other parts of this chapter.

[B] SEC Examinations and Enforcement

Advisers Act registration subjects registered advisers to periodic and special examinations of the adviser's books and records conducted by the SEC's Office of Compliance Inspections and Examinations (OCIE). OCIE conducts these examinations to determine the level of the adviser's compliance with the Advisers Act and other federal securities laws. Although the SEC has indicated that Exempt Reporting Advisers will not be subject to routine examinations, Exempt Reporting Advisers are subject to "for cause" examinations.

OCIE conducts several types of examinations, including periodic, for cause, and sweep examinations. Periodic examinations of registered advisers occur generally every three to four years, although more frequent examinations may occur depending on a variety of factors, including the adviser's size, strength of internal controls, and previous OCIE examination results. Based on these and other factors, advisers are assigned a risk profile which weighs heavily in determining the frequency of OCIE examinations. Pursuant to OCIE's National Exam Program (NEP), OCIE has been conducting so-called "Presence Exams" of new registrants since 2012. These are targeted exams that focus on a limited number of high-risk areas of an adviser's business. If deficiencies are detected in these areas, examiners may expand the scope of a Presence Exam to that of a full-scale exam.

As noted in chapter 9, in the first round of presence exams for private equity managers, the staff of the SEC found that more than 50% of the private equity fund managers examined violated the law or had material internal control weaknesses with respect to fees and expenses—a "remarkable statistic."[17] In his May 2014 speech, then-Director Andrew Bowden specifically noted concerns with private equity managers shifting expenses from themselves to their clients without proper disclosure and contrary to the reasonable expectation

16. 15 U.S.C. § 80b-6.
17. *See* chapter 9, Adopting a Compliance Program.

of such clients.[18] The staff also stated that deficiencies were commonly seen in a private equity manager's use of consultants, also known as "operating partners," who provide portfolio companies with consulting services or other assistance, and who often look and act just like other employees of the manager. However, unlike other employees of the manager, many of these operating partners are paid directly by portfolio companies or the funds without sufficient disclosure to investors. The staff noted other examples of fee-shifting, including billing funds for various back-office functions that have traditionally been included as services provided in exchange for the management fee—including internal compliance, legal, and accounting—without proper disclosure that these costs are being shifted to the funds.

In addition to fee-shifting, the staff noted that some private equity managers were charging hidden fees that are not adequately disclosed to investors. Examples of such hidden fees may include: accelerated monitoring fees; administrative, transaction, or other fees not contemplated by the operating documents; fees exceeding the limits set in the operating documents; and fees to related-party service providers who deliver services of questionable value.

Finally, in the speech the staff discussed the marketing and valuation practices of private equity managers. With respect to valuation, the staff stated that some managers were inflating valuations during periods of fundraising, changing valuation methodology to one that is inconsistent with the manager's overall valuation policy or without proper disclosure to investors, cherry-picking comparables and adding back inappropriate items to EBITDA. The staff noted they are reviewing marketing materials to look for inconsistencies and misrepresentations. Some areas of particular focus are performance marketing and insufficient disclosure during periods of fundraising.

In February 2014, OCIE sent a letter to advisers announcing that the NEP was launching a new initiative (the "Never-Before Examined Initiative") to examine those investment advisers that have never been examined, with an emphasis on those advisers that have been registered three years or more. The NEP announced that they would be taking two different approaches in these exams: (1) a risk-assessment approach meant to better understand the registrant, which will focus on the compliance program and disclosures; and (2) a focused review approach, which will include comprehensive exams of high-risk areas such as the compliance program, filings/disclosures, marketing, portfolio management, and safety of client assets.

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18. Andrew Bowden, Dir. of the SEC Office of Compliance Inspections & Examinations, Remarks Before the Private Equity International (PEI), Private Fund Compliance Forum 2014: Spreading Sunshine in Private Equity (May 4, 2014).

OCIE can also conduct "for cause" examinations if it has reason to believe that an adviser has violated the federal securities laws. These examinations are often triggered by client complaints, rumors, tips, or negative press coverage. OCIE can also conduct "sweep" examinations which do not target an individual adviser, but rather a particular practice. These examinations are limited in scope but can potentially cover a large number of advisers.[19]

An adviser's books and records serve as a roadmap for conducting OCIE examinations. Rule 204-2[20] of the Advisers Act requires registered advisers to keep certain enumerated books and records, including, among other things, organizational documents, trade records and backup client communications, advertisements and other marketing materials, performance backup records, custody records, policies and procedures, and information documenting the annual review of the adviser's compliance program. In addition to books and records, OCIE examiners will often conduct interviews of the adviser's employees.

If examinations do not unearth any violations, the SEC will issue a "no further action" letter, although this does not occur frequently. The vast majority of the time, OCIE will issue a deficiency letter which details alleged violations and requires the adviser to respond to the deficiency letter within thirty days of issuance. In most cases, these violations are relatively technical, and can be corrected or rebutted. Where major securities law violations are uncovered, OCIE will refer the matter to the SEC's Enforcement Division for potential enforcement action, and the SEC can bring administrative and other proceedings to determine whether any violation has occurred and whether discipline is necessary.

Pursuant to various provisions of section 203 of the Advisers Act, the SEC has authority to discipline an adviser, whether registered[21] or unregistered, including the authority to impose cease-and-desist orders, censure advisers, require disgorgement of ill-gotten gains, impose civil monetary penalties, and suspend or expel an adviser from the securities industry.

If a private equity fund manager is subject to an SEC examination, it is recommended that the private equity fund manager coordinate closely with its counsel to prepare for and respond to the SEC examination. Private equity fund managers should also prepare in advance for an SEC examination so that the manager has all required books and records and is prepared to respond promptly to the SEC's

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19. For example, in February 2012, the SEC commenced a sweep investigation of the private equity industry to examine the industry's valuation practices. *See* Gregory Zuckerman, *SEC Launches Inquiry Aimed at Private Equity*, WALL ST. J., Feb. 11, 2012.
20. 15 U.S.C. § 80b-4c.
21. 15 U.S.C. § 80b-3.

numerous requests for information in an examination. Many investment advisers will also prepare a first day presentation for the SEC in an examination so that the adviser and its senior officers can introduce the firm to the SEC and describe the firm's investment strategies, clients, risks and compliance program designed to address those risks.

Private equity fund managers should prepare for the SEC to review all areas of its business, investments, and compliance program in an exam. SEC examinations may span a few weeks to many months (or in excess of a year) depending on the particular exam and the private equity fund manager's preparedness and strength (or weakness) of its compliance program.

Private equity fund managers should pay particular attention to those areas the SEC has stated are focus areas for private equity, as more fully discussed in this chapter, including:

- Investment Strategy
- Investment Allocation, including with respect to Co-Investments
- Fees and Expenses
- Custody
- Valuation
- Advertising and Marketing
- Cybersecurity

SEC examinations, and the results of such examinations, also can pose challenging fiduciary, disclosure, and investor relations questions for private equity fund managers. As such, managers should discuss these issues with their advisers in the event the manager is subject to an SEC examination.

[C] Performance-Based Compensation

The Advisers Act also imposes substantive restrictions on the method of client compensation available to registered advisers. Unless an exemption is available, section 205(a) of the Advisers Act[22] prohibits registered advisers from receiving "compensation on the basis of a share of capital gains upon or capital appreciation of funds or any portion of the funds of the client."[23] This prohibition on performance-based compensation impacts private equity fund managers and fund general partners that rely heavily on the carried interest they receive from the fund.

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22. 15 U.S.C. § 80b-5(a).
23. *Id.*

§ 12:5 Substantive Provisions of the Advisers Act

§ 12:5.1 Section 206: Anti-Fraud Provisions

[A] Generally

Although investment advisers, both SEC registered and unregistered, have common-law fiduciary duties of care and loyalty to their clients,[57] these duties can be modified or perhaps even eliminated by contract under Delaware law. By contrast, the U.S. Supreme Court has held that the Advisers Act's broad anti-fraud provisions impose statutory fiduciary duties on investment advisers, including an affirmative duty of "utmost good faith" to act in the best interest of the client *and* the duty to "provide full and fair disclosure of all material facts" that may have an impact on an investment adviser's independence and judgment,[58] and advisers do not have the same latitude to contractually modify these duties as they do these common-law analogs. Section 206 of the Advisers Act[59] makes it unlawful for any investment adviser to:

- employ any device, scheme, or artifice to defraud any client or prospective client (section 206(1));
- employ any device, scheme or artifice to defraud, or to engage in any act, transaction, practice, or course of business that operates as a fraud or deceit on any client or prospective client (section 206(2));
- act as a principal for its own account, knowingly to sell any security to or purchase any security from a client, or act as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of any such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he/she is acting, and obtaining the consent of the client to such transaction (section 206(3));
- engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative (section 206(4)).

These prohibitions are quite broad as they apply both to registered and unregistered advisers, are not limited to specific conduct such as the purchase and sale of securities, and do not require actual injury to

57. *See* chapter 6, Ownership and Compensation Arrangements for Fund Sponsors.
58. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).
59. 15 U.S.C. § 80b-6.

a client or investor to establish a violation. Additionally, in the case of section 206(2) and section 206(4), the SEC takes the position that showing that the adviser acted with simple negligence is sufficient to establish a violation of such provisions.[60]

In addition to these explicit prohibitions, courts have read into the Advisers Act certain fiduciary obligations that investment advisers must fulfill to their clients. For instance, an investment adviser has an obligation to provide only suitable recommendations to its clients. Similar to the suitability obligation, an investment adviser has a related fiduciary duty to conduct reasonable due diligence with respect to any security or other financial instrument that it acquires for its clients so that the investment adviser has a reasonable basis for making an investment recommendation. Additionally, an investment adviser is obligated to purchase and sell only securities or other financial instruments that are consistent with its clients' investment objectives.[61]

The most often cited violations under the Advisers Act are in connection with section 206(1) and 206(2) of the Advisers Act, which have been used to sanction the following types of behavior (some of which can occur in the private equity context while others are more likely in the context of active trading of public securities):

- Front-running of securities, where an investment adviser or its personnel purchases securities for their accounts prior to purchasing the same securities for client accounts or sells securities in their accounts prior to selling the same securities for client accounts;[62]
- Scalping, which is a practice whereby an investment adviser or its employees purchase securities for their own accounts prior to recommending them for purchase by their clients;
- Misrepresenting pricing methodology and failure to follow stated valuation procedures;[63]

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60. SEC v. Steadman, 967 F.2d 636 (D.C. Cir. 1992). Note, however, that the Advisers Act does not offer investors a private right of action.
61. 15 U.S.C. § 80b-6(1), (2).
62. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963); *In re* Michael L. Smurlock, Investment Advisers Act Release No. 1393, at n.4 (Nov. 29, 1993); *In re* Kingsley, Jennison, McNulty & Morse, Inc. et al., Admin. Proc. File No. 3-7446 (Nov. 14, 1991), Investment Advisers Act Release No. 1396 (Dec. 23, 1993).
63. SEC v. Beacon Hill Asset Mgmt., LLC, et al., No. 02 CV 8855 (LAK) (S.D.N.Y. June 15, 2004); *In re* Askins Capital & David J. Askin, Investment Advisers Act Release No. 1492 (May 23, 1995); SEC v. Michael L. Smirlock, et al., 00 Civ. 9680 (RO) (S.D.N.Y. Dec. 21, 2000); *In re* Stephen H. Brown, Investment Advisers Act Release No. 1751 (Sept. 14, 1998).

- Mispricing of portfolio securities or market manipulation of securities prices to inflate value of portfolio;[64]
- Failing to mention that portfolio performance was materially impacted by purchases of initial public offering (IPO) securities;[65]
- Misrepresenting internal controls;[66]
- Miscoding, forging, or failing to submit order tickets;[67]
- Overstating performance results;[68]
- Purchasing securities for accounts in contravention of prospectus or offering document disclosures;[69]
- Favoring certain client accounts over others in allocation of investment opportunities without full and fair disclosure;[70]

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64. *In re* Van Kampen American Capital Mgmt., Inc., Investment Advisers Act Release No. 1525 (Sept. 29, 1995); *In re* Andrew S. Parlin, Investment Advisers Act Release No. 1967 (Aug. 10, 2001); SEC v. Burton G. Friedlander, et al., No. 01 Civ. 4683 (KMV) (S.D.N.Y. Oct. 24, 2003).
65. *In re* John McStay Investment Counsel L.P., Investment Advisers Act Release No. 2153 (July 31, 2003); *In re* The Dreyfus Corp. et al., Investment Advisers Act Release No. 1870 (May 10, 2000); *In re* Van Kampen Investment Advisory Corp. et al., Investment Advisers Act Release No. 1819 (Sept. 8, 1999).
66. *In re* First Capital Strategies et al., Investment Advisers Act Release No. 1648 (Aug. 13, 1997).
67. *In re* Scudder Kemper Investments, Investment Advisers Act Release No. 1848 (Dec. 22, 1999); *In re* Michael T. Sullivan, III, Investment Advisers Act Release No. 1849 (Dec. 22, 1999).
68. *In re* Angelo Haligiannis, Investment Advisers Act Release No. 2441 (Oct. 12, 2005); United States v. Haligiannis, 04 Civ. 1058 (S.D.N.Y. 2005); SEC v. Beacon Hill Asset Mgmt., LLC et al., No. 02 CV 8855 (LAK) (S.D.N.Y. June 15, 2004); SEC v. Anthony Postiglione, Jr., et al., Civ. Act. No. 04-CV-3604 (E.D. Pa. July 30, 2004); SEC v. SnyamicDaytrader.com LLC, et al., Litig. Release No. 16,475 (Mar. 20, 2000); *In re* First Capital Strategists et al., Investment Advisers Act Release No. 1648 (Aug. 15, 1997).
69. *In re* Stephen H. Brown, Investment Advisers Act Release No. 1751 (Sept. 14, 1998); *In re* Mitchell Hutchins Asset Mgmt., Inc., Investment Advisers Act Release No. 1654 (Sept. 2, 1997).
70. SEC v. Alan Brian Bond, et al., Litig. Release No. 17,099 (Aug. 10, 2001); SEC v. Timothy J. Lyons, Investment Advisers Act Release No. 1882 (June 20, 2000); *In re* Monetta Fin. Servs., Inc., et al., Admin. Proc. File No. 3-9546, 72 SEC Docket 77, 2000 WL 320457 (Mar. 27, 2000); *In re* The Dreyfus Corp. et al., Investment Advisers Act Release No. 1870 (May 10, 2000); *In re* F.W. Thompson Co., Ltd. et al., Investment Advisers Act Release No. 1895 (Sept. 7, 2000); *In re* McKenzie Walker Investment Mgmt., Inc. et al., Investment Advisers Act Release No. 1571 (July 16,

- Misallocation of expenses to fund clients or between fund clients;[71]
- Misappropriating investment opportunities belonging to fund clients;[72]
- Entering into undisclosed commission-splitting arrangements;[73]
- Failing to disclose brokerage commission or service fees from client investments;[74]
- Failing to disclose soft dollar arrangements;[75]
- Failing to disclose that an adviser would profit in transactions acting as a principal with clients;[76]
- Misappropriating client funds;[77]

1996); *In re* Account Mgmt. Corp. et al., Investment Advisers Act Release No. 1529 (Sept. 29, 1995); *In re* John Guira et al., Investment Advisers Act Release No. 1095 (Nov. 13, 1987); *In re* Shearson Lehman, Inc. et al., Investment Advisers Act Release No. 1038 (Sept. 24, 1986).

71. *In re* Clean Energy Capital, LLC, Investment Advisers Act Release No. 3955 (Oct. 17, 2014); *In re* Lincolnshire Management, Inc., Investment Advisers Act Release No. 3927 (Sept. 22, 2014).

72. *In re* Schwendiman Partners, LLC, Investment Advisers Act Release No. 1446 (Sept. 30, 1994); *In re* Ronald L. Speaker et al., Investment Advisers Act Release No. 1605 (Jan. 13, 1997).

73. *In re* Thomas J. Bowne, Investment Advisers Act Release No. 1468 (Feb. 10, 1995); *In re* Capital Markets Research Co. & Paul Edward Holl, Investment Advisers Act Release No. 1834 (Sept. 27, 1999).

74. *In re* Michael C. Robertson et al., Investment Advisers Act Release No. 1581 (Sept. 26, 1996); *In re* Winfield & Co., Inc. et al., Exchange Act Release No. 9478 (Feb. 9, 1972).

75. Failure to disclose potential conflicts of interest with clients; *In re* Dawson Samberg Capital Mgmt., Inc. et al., Investment Advisers Act Release No. 1889 (Aug. 3, 2000); *In re* Oakwood Counselors, Inc. et al., Investment Advisers Act Release No. 1614 (Feb. 10, 1997); *In re* Marvin & Palmer Assocs. et al., Investment Advisers Act Release No. 1841 (Sept. 30, 1999).

76. SEC v. Thomas E. Lloyd, et al., Litig. Release No. 16,495 (Mar. 31, 2000); SEC v. Yun Soo Oh Park, et al., Litig. Release No. 16,399 (Jan. 5, 2000); *In re* John J. Kaweske, Investment Advisers Act Release No. 1539 (Nov. 27, 1995); *In re* Roger W. Honour, Investment Advisers Act Release No. 1527 (Sept. 29, 1995); *In re* Chancellor Capital Mgmt., Inc. et al., Investment Advisers Act Release No. 1447 (Oct. 18, 1994).

77. *In re* Marc N. Geman, Admin. Proc. File No. 3-9032, 65 SEC Docket 339, 1997 WL 436272 (Aug. 5, 1997); *In re* Rauscher Pierce Refsnes, Inc. et al., Investment Advisers Act Release No. 1863 (Apr. 6, 2000).

- "Interpositioning" a broker between a fund and dealers making a primary market in securities, causing the fund to incur unnecessary expenses;[78]
- Failing to disclose the fact that prices realized were not the most favorable under the circumstances;[79]
- Failing to seek best execution on the client's behalf;[80]
- Failing to disclose that client commissions were used to pay brokers for client referrals;[81] and
- Involvement in bribery schemes.[82]

[B] Potential Conflicts of Interest

Sections 206(1) and 206(2) are also designed to promote full and fair disclosure of information which may impair an adviser's judgment and independence, which are important factors investors may require in making informed investment decisions.

Therefore, before a private equity fund sponsor begins drafting fund offering documents, it is imperative to consider those potential or actual conflicts of interest which will require disclosure in the fund's offering documents. For instance, depending on the private equity sponsor, it may be important to disclose one or more of the following conflicts:

- The adviser is not obligated to spend all of his time performing his duties on behalf of the fund;
- The adviser and its affiliates may perform similar advisory functions on behalf of other investment funds and on behalf

78. *In re* Portfolio Advisory Servs., LLC, Investment Advisers Act Release No. 2038 (June 20, 2002); *In re* Edgemont Asset Mgmt. Corp. & Bowling Green Securities, Inc., Investment Advisers Act Release No. 1280 (June 18, 1991).

79. *In re* Portfolio Mgmt. Consultants, Inc., Investment Advisers Act Release No. 1568 (June 27, 1996).

80. *In re* Fleet Investment Advisers, Inc., Investment Advisers Act Release No. 1821 (Sept. 9, 1999).

81. *In re* Portfolio Advisory Services, LLC, Investment Advisers Act Release No. 2038 (June 20, 2002); *In re* Duff & Phelps Investment Mgmt. Co., Inc., Investment Advisers Act Release No. 1984 (Sept. 28, 2001); *In re* Founders Asset Mgmt., LLC et al., Investment Advisers Act Release No. 1879 (June 15, 2000); *In re* Fleet Investment Advisors, Inc., Investment Advisers Act Release No. 1821 (Sept. 9, 1999).

82. *In re* Thayer Capital Partners et al., Investment Advisers Act Release No. 2276 (Aug. 12, 2004); SEC v. Paul J. Silverste, et al., Litig. Release No. 1675 (Oct. 10, 2000); *In re* William M. Stephens, Admin. Proc. File No. 3-10231, Release No. 33-7866, Release No. 34-42941, 72 SEC Docket 1575, 2000 WL 766692 (June 14, 2000).

member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust, that gives the investment manager legal ownership of or access to client funds or securities.

The custody rule imposes specific conditions on registered investment advisers who have actual or deemed custody of client assets, including maintaining client assets with a "qualified custodian," providing notices to clients regarding the qualified custodian and manner in which the funds or securities are maintained, delivering account statements to clients, and being subject to independent audits by an independent public accountant at least once during each calendar year ("surprise audit").

Most private equity managers utilize the "pooled vehicle annual audit exception" with respect to the private funds that they manage. This exception exempts such private funds from the custody rule requirements related to client notices, account statements, and the surprise audits discussed above. A private equity manager may utilize the "pooled vehicle annual audit exception" with respect to a private fund if audited financial statements prepared in accordance with generally accepted accounting principles are distributed to all fund investors annually within 120 days of the end of the fund's fiscal year and if the fund is subject to an audit upon liquidation.

Private equity managers that are registered investment advisers must maintain applicable client assets with a qualified custodian. There are limited exceptions for certain non-transferable, "privately offered securities" if the private equity manager utilizes the pooled vehicle annual audit exception.

Many private equity fund managers establish or control special purpose vehicles (SPVs) for certain investments of the pooled investment vehicles they manage. Recent guidance from the SEC[126] suggests that, if an SPV has third party investors and is an investment advisory client (based on the facts and circumstances), the private equity manager may need to prepare separate audited financial statements with respect to such SPV's assets.

§ 12:5.9 Fees and Expenses

As noted above, allocation of fees and expenses to clients by private equity managers is a major regulatory compliance concern for the SEC as evidenced in recent SEC enforcement actions.

126. SEC Division of Investment Management, IM Guidance Update No. 2014-07, Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows (June 2014).

In an action against Clean Energy Capital (CEC), the SEC found that CEC misallocated certain expenses among the funds it managed because CEC allocated the majority of expenses applicable to more than one fund ("split expenses") across all of its funds identically based on each fund's net capital contributions, although the actual expense may not have been incurred by a particular fund.[127] For eight of CEC's funds, the offering and operating documents did not disclose that such funds would bear the split expenses and CEC's Forms ADV also did not disclose the sharing of expenses between the funds. The SEC further found that by allocating the majority of the CEO's compensation to CEC's funds, CEC and the CEO breached their fiduciary duties to the funds because the allocation of these expenses to the funds constituted a conflict of interest that was not expressly disclosed in the funds' governing documents.

In the action against Lincolnshire Management, Inc. (LMI), the SEC found that LMI misallocated expenses between two portfolio companies (which were operationally integrated, but separate legal entities owned separately by two LMI funds) because LMI did not follow its expense allocation policy.[128] This resulted in one portfolio company paying more than its share of certain expenses that benefitted both companies. The SEC further noted that there was no written agreement between the portfolio companies relating to sharing or allocating expenses.

In an action against Blackstone Management Partners LLC ("Blackstone"), the SEC alleged that Blackstone and certain of its affiliates breached their fiduciary duty to clients by failing to disclose discounts it received on legal fees being provided to the advisory entities, but not to the funds, and failing to disclose its ability to accelerate monitoring fees to be paid in the future prior to the submission of capital commitments.[129] The SEC further alleged that Blackstone had inadequate written policies and procedures reasonably designed to prevent conflicts of interest. Blackstone agreed to pay $26,225,203 in disgorgement, $2,686,553 in prejudgment interest, and a $10-million civil penalty to settle the matter.

In an action against Kohlberg Kravis Roberts & Co. LP (KKR), the SEC alleged that KKR breached its fiduciary duty to clients by misallocating expenses to clients by failing to allocate "dead deal"

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127. *In re* Clean Energy Capital, LLC, Investment Advisers Act Release No. 3955 (Oct. 17, 2014).

128. *In re* Lincolnshire Management, Inc., Investment Advisers Act Release No. 3927 (Sept. 22, 2014).

129. In the Matter of Blackstone Management Partners L.L.C., et al., Investment Advisers Act Release No. 4219 (Oct. 7, 2015).

expenses to its co-investors (many of whom were internal firm personnel), and for failing to adopt and implement a written compliance policy or procedure regarding its fund expense allocation practices.[130] KKR agreed to pay over $28 million in total to settle the action.

§ 12:5.10 Broker-Dealer Registration

In a 2013 speech, the former chief counsel of the SEC's Division of Trading and Markets discussed certain private equity fund practices of collecting many other fees in addition to advisory fees in connection with portfolio company transactions, and the question of whether those advisers are engaging in activities that may require broker-dealer registration.[131] In this speech, the offsetting of transaction fees against management fees was identified as potentially mitigating concerns about a need to register as a broker-dealer.

The SEC recently charged a private equity fund manager, Blackstreet Capital Management LLC ("Blackstreet"), with several violations of law, including failure to register as a broker-dealer.[132] Blackstreet, its principal, and managing member settled charges that they engaged in conflicted transactions, improperly used fund assets, and failed to adequately disclose fees and expenses paid by the funds and portfolio companies owned by those funds. The failure to register charge arose out of the receipt of fees in connection with portfolio company transactions. The limited partnership agreement for the funds expressly permitted the firm to charge transaction or brokerage fees, but there is no indication that Blackstreet offset the transaction fees it received against management fees. The facts of this case are unique; however, private equity managers taking transaction fees should evaluate their particular situation, types of transactions and fees, whether they are offsetting these fees against management fees, and whether broker-dealer registration may be required.

§ 12:5.11 Adviser Compliance Policies and Procedures

The SEC enacted Rule 206(4)-7 of the Advisers Act to promote enhanced compliance with the Advisers Act by registered advisers. Rule 206(4)-7 requires, among other things, that registered advisers:

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130. In the Matter of Kohlberg Kravis Roberts & Co. L.P., Investment Advisers Act Release No. 4131 (June 29, 2015).

131. David W. Blass, Chief Counsel, Div. of Trading and Mkts., U.S. Sec. and Exch. Comm'n, Remarks Before the American Bar Association, Trading and Markets Subcommittee: A Few Observations in the Private Fund Space (Apr. 5, 2013).

132. In the Matter of Blackstreet Capital Management, LLC, SEC Release No. 34-77959 (June 1, 2016).

NOTES