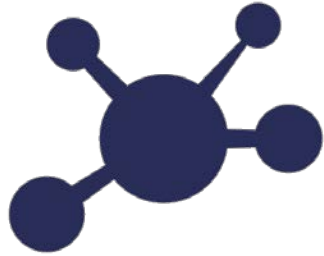




# Risk and Return: The Intent and Impact of Evolving Regulation

## Philadelphia, PA | October 7, 2016



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# Risk and Return:

# The Intent and Impact of Evolving Regulation

Institutional Limited Partners Association  
Philadelphia LPs-Only Educational Workshop  
October 7, 2016

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- Current SEC Initiatives and Inspection Trends
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# SEC FOCUS ON PRIVATE EQUITY

THE WALL STREET JOURNAL.

*“Private Equity Firms Move Into  
SEC Crosshairs.”*

Source: “Private-Equity Firms Move Into SEC Crosshairs”, *Wall Street Journal*, August 19, 2016.

# SEC INITIATIVES

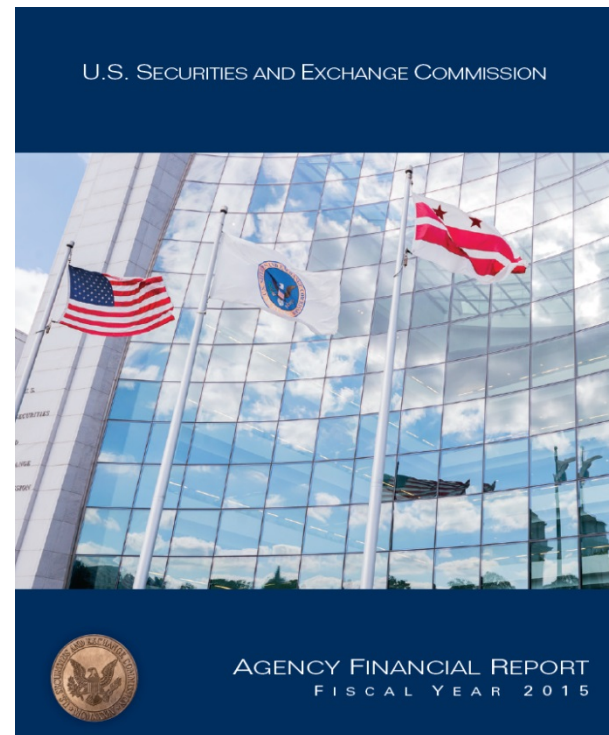
- Priority on Enforcement
  - Broken Windows
  - Whistleblowing Program
- Staffing
  - Private Funds Unit
  - Adding 100 IA examiners in 2016
- Technology
  - Division of Economic and Risk Analysis
  - Quantitative Analytics Unit
- Risk-Based Audits
- Thematic Audits





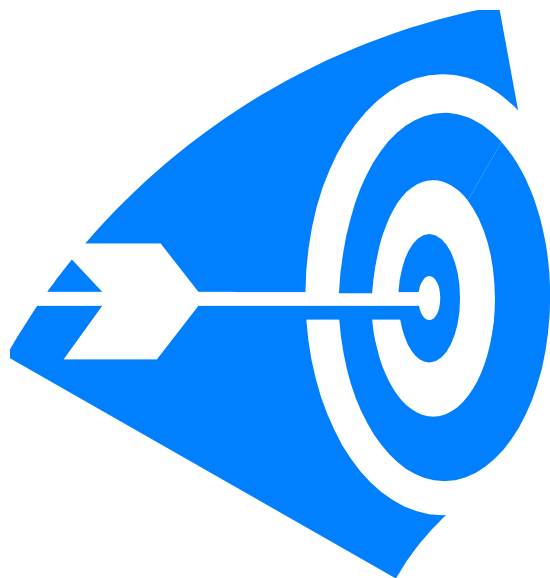
# SEC ANNUAL ENFORCEMENT STATISTICS

- Division of Enforcement filed a record **807 enforcement actions** in FY 2015 (compared to 755 in 2014)
- Charged **87 people** with insider trading (compared to 44 in 2013 and 80 in 2014)
- Obtained orders totaling **\$4.2 billion** in disgorgement and penalties (compared to \$4.16 billion in 2014)
- Awarded whistleblowers **\$38 million** (compared to \$35 million in 2014)



Source: U.S. Securities and Exchange Commission, *FY 2015 Annual Performance Report*, November 13, 2015.

# SEC INSPECTION PRIORITIES FOR 2016



- Cybersecurity
- Fees and Expenses
- Protecting Retail Investors
  - BDCs
- Reg D Offerings
- NBE Advisers

Source: "SEC Announces 2016 Examination Priorities", *SEC Press Release No. 2016-4*, January 11, 2016.



# SEC FOCUS ON CYBERSECURITY

- SEC continues to review the control environment in 2016
- Examiners expect to see results of gap analyses
- Focus areas include:
  - Governance and Risk Assessment
  - Access Rights and Controls
  - Data Loss Prevention
  - Vendor Management
  - Training
  - Incident Response
  - Portfolio Company Due Diligence
- Intent to bring more enforcement cases following the RT Jones case



# MORE CYBERSECURITY CASES TO COME...

*“While cybersecurity attacks cannot be entirely eliminated, it is incumbent upon private fund advisers to employ robust, state-of-the-art plans to prevent, detect, and respond to such intrusions.”*

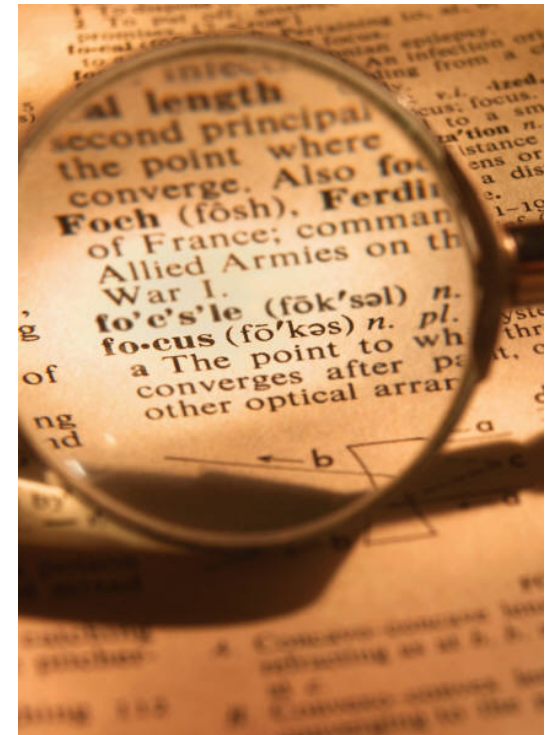
- Mary Jo White, SEC Chair



Source: “Five Years On: Regulation of Private Fund Advisers after Dodd-Frank”, Speech by SEC Chair Mary Jo White at the MFA Outlook 2015 Conference, October 16, 2015.

# SEC FOCUS ON FEES AND EXPENSES

- Are they appropriate, in general?
  - Fund OMs
  - Fund LPAs
  - Advisory Board disclosures and approvals
  - Part 2 of Form ADV
- Are they allocated correctly?
  - Funds
  - Co-investment vehicles and investors
  - Portfolio companies
  - Management company



# FEES AND EXPENSES CASE STUDY

- New York-based private equity firm
- Accelerated monitoring fees without LP consent
- Terms of loans from funds to their GPs were inaccurately disclosed
- Failed to supervise a senior partner who improperly charged personal expenses to funds and portfolio companies
- Failed to adopt written policies and failed to follow written T&E policies
- Proactively initiated expense reviews and voluntarily reported issues to the SEC
- Paid **\$37.5M** in disgorgement, **\$2.7M** in prejudgment interest, and a **\$12.5M** penalty

*“A common theme in our recent enforcement actions against private equity firms is their failure to properly disclose fees and conflicts of interest to fund investors,”*

\*Firm neither admitted nor denied the SEC's findings in settling the enforcement action

Source: *Apollo Charged with Disclosure and Supervisory Failures*, [SEC Press Release](#), August 23, 2016.

# SEC FOCUS ON UNREGISTERED BROKER-DEALER ACTIVITY

*“That’s the first case of a private-equity adviser violating section 15(a) of the [Securities Exchange Act of 1934] for acting as a broker and failing to register as a broker,” he said. “Advisers should be carefully considering whether their conduct violates this rule...”*

- Robert B. Baker, Assistant Regional Director, Asset Management Unit

June 7, 2016

# UNREGISTERED B-D CASE STUDY

- Maryland-based private equity firm
- Collected transaction-based compensation in connection with the purchase and sale of portfolio companies
- However, the firm was not registered as, or affiliated with, a broker
- Fund LPAs expressly permitted the charging of transaction and brokerage fees
- Other issues related to fees, expenses, and conflicts of interest were also alleged
- Paid **\$2.3M** in disgorgement, **\$283K** in prejudgment interest, and a **\$500K** penalty

*“The rules are clear: before a firm provides brokerage services and receives compensation in return, it must be properly registered within the regulatory framework that protects investors and informs our markets,”*

\*Firm neither admitted nor denied the SEC's findings in settling the enforcement action

Source: SEC: Private Equity Adviser Acted As Unregistered Broker, [SEC Press Release](#), June 1, 2016.



# END OF LIFE FUNDS AND MANAGERS

*“There were **more than 1000 zombie funds** – past-term vehicles managed by GPs unlikely to raise a successor vehicle – as of July [2015], **almost half of which were in the US**, according to PEI Research & Analytics.”*

Source: “GP-led restructurings in SEC’s sights”, *private funds management*, February 8, 2016.

# SEC FOCUS ON “ZOMBIES”

*“Since zombie managers are unable to raise new capital, their incentives may shift from maintaining good relations with their investors to maximizing their own revenue using the assets that they have.”*



- Bruce Karpati, then Chief of the SEC Enforcement Division's Asset Management Unit

# SEC EXAM REQUESTS

- n. Whether the fund is currently in-the-money or out-of-the-money for earning carried interest;
- o. Whether the fund is currently in a clawback position and the amount of the clawback;
- p. Names of all qualified custodians at which funds or securities are held;
- q. Whether the fund is audited annually and, if so, name of auditor (including the contact person, address, phone number, email address);
- r. Date of delivery to investors of the most recent audited financial statements for each private fund. Please include supporting documentation;
- s. Indicate the date in which the investment period ended for each private fund; and
- t. Indicate any funds that have been extended beyond their expected lifespan, investment period or commitment period. If so, please provide details regarding such extension, including the date the extension was requested and approved, type of extension (e.g. investment, commitment) and whether approval was sought and received by the Advisory Board.

# ZOMBIE FUND CASE STUDY

- New York-based private equity firm
- Received monitoring fees from portfolio companies, which were subject to fee offsets
- Terminated monitoring agreements and caused portfolio companies to engage an affiliated consulting firm
- Fees received by affiliated consulting firm were not subject to offset
- Partners and employees received undisclosed CIP compensation from a portfolio company
- Affiliated consulting firm received an undisclosed consulting fee
- Failed to disclose conflicts of interest
- Paid total of **\$7.8M** in disgorgement, **\$824K** in prejudgment interest, and a **\$1.5M** penalty

*“SEC Charges Private Equity Firm and Four Executives With Failing to Disclose Conflicts of Interest”*

\*Firm neither admitted nor denied the SEC's findings in settling the enforcement action

Source: *SEC Charges Private Equity Firm and Four Executives With Failing to Disclose Conflicts of Interest*, [SEC Press Release](#), November 3, 2015.

# THE CASPERSEN FRAUD

- Partner at a placement agent and previously a secondaries manager
- Solicited investments in a purportedly restructured fund
- Set up bogus shell entities, internet domain names, and email addresses
- Name of the shell company was deceptively similar to a legitimate PE fund
- Successfully obtained \$25M, mostly from a charitable organization affiliated with a hedge fund founder
- Pled guilty and will be sentenced November 2, 2016



Source: *Securities Professional Charged With Defrauding Institutional Investors* , [SEC Press Release](#), March 28, 2016.

# GP AND LP OPTIONS

- Cross Fund Transactions
- In-Kind Distributions
- Principal Transactions
- Fund Extensions
- Restructurings
- Management Assignments
- Secondaries Transactions





# RISKS AND CONSIDERATIONS

- Consent
  - Will LP or LPAC consent be appropriately obtained?
    - Who provides consent in the event of a stapled transaction?
  - Have all material facts and conflicts of interest been disclosed?
    - Has full transparency been provided to all LPs?
    - “Everyone has already signed up to the deal but you”
    - Are performance track records being presented accurately?
      - Cherry picking, gross or net, effect of non-fee paying capital, use of credit lines
  - Will consent be documented in writing?
  - Are the LPACs themselves conflicted?
    - Would the outcome be different if certain members recused themselves?

# RISKS AND CONSIDERATIONS

- Fees

- Will fund management fees continue?
- Will portfolio company monitoring fees continue?
  - Are services still being provided in exchange for such fees?
- Will transaction fees be taken?
- Will any new revenue streams be initiated?

- Expenses

- Will allocation methodologies change?
- Will new service providers be engaged?
  - Are any affiliated with the GP?

# RISKS AND CONSIDERATIONS

- Management
  - Who will continue to manage the fund or investment?
  - Should management be replaced?
- Valuation
  - How is or will the valuation be derived?
  - Will a third party be engaged to provide a valuation opinion?
  - Will LPs or the LPAC have the opportunity to review and approve?
- Safeguarding
  - How will evidence of ownership be handled and appropriately safeguarded?
- Reporting
  - Will audits continue?
  - Will enhanced reporting be provided?

# QUESTIONS



# THANK YOU!



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# LUKE WILSON



Luke is a Partner based in Austin, Texas. He specializes in SEC compliance for advisers to private equity funds, private real estate funds, venture capital funds, hedge funds, and other types of private funds. In this role, he coordinates the development, implementation, and maintenance of customized compliance programs. He also coordinates and conducts mock regulatory examinations, supports ACA clients during actual SEC examinations, and performs annual compliance program reviews. Further, he specializes in identifying client-specific risks and conflicts of interest. In addition to his consulting work, Luke speaks at industry events, participates on panels of industry experts, and writes articles on current compliance issues for widely read industry periodicals. He also serves as a member of the Advisory Board of the Private Equity CFO Association, Dallas Chapter.

Prior to joining ACA in 2006, Luke served as a Securities Compliance Examiner at the SEC's Chicago Regional Office. While at the SEC, he took part in or led several examinations that were referred to the SEC's Division of Enforcement for further investigation. Luke also participated in Risk Targeted Examination Sweeps of advisers to private funds and high-yield municipal bond funds, as well as exams conducted pursuant to Chairman Cox's Senior Initiative. In addition, he trained new SEC employees on examination techniques and represented the SEC on panels of industry professionals.

Luke graduated cum laude from the University of Dayton with a B.S. in Finance.





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