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Client Alert
Commentary

Latham & Watkins Investment Funds Practice and Private Equity Practice

February 9, 2016 | Number 1924

Private Equity Fund Managers: Annual Compliance Reminders and New Developments

Summary of private equity firms' compliance obligations, discussion of notable developments in 2015 and outlook for 2016.

US federal laws and regulations, as well as the rules of self-regulatory organizations (SROs), impose numerous yearly reporting and compliance obligations on private equity firms. In addition to many routine and ongoing requirements, new and emerging regulatory developments also impact private equity firms' compliance operations. This *Client Alert* provides a round-up of certain annual or periodic investment advisory compliance-related requirements that apply to many private equity firms. It also highlights material regulatory developments in 2015 and expectations for 2016.

A complete review of a private equity firm's compliance obligations is beyond the scope of this *Client Alert*, as operational aspects unique to a particular firm may entail additional regulatory obligations or different timelines for compliance.

Annual Compliance Reviews

Investment advisers registered under the Investment Advisers Act of 1940, as amended (the Advisers Act), are required to review compliance programs annually for adequacy and effectiveness. These annual compliance reviews continue to be a focal point of SEC inspections. Chief Compliance Officers (CCOs) of private equity firms should consider whether their compliance documentation appropriately addresses applicable compliance areas, including:

- Collect annual certifications from all "supervised persons," certifying that each has read and understood the compliance policies and procedures, and collect an annual personal securities holding report from each "access person"
- Update, maintain and deliver to clients, as applicable, Form ADV Part 2B (the brochure supplement)
- Review private fund offering materials and determine if updates are required (*e.g.*, for material changes in the adviser's investment objective, strategies, performance, risks and conflicts of interest)
- Distribute annual privacy notice to natural-person clients or investors[1]
- Obtain annual re-certifications regarding the absence of "bad actor" status pursuant to Securities Act Rule 506(d)
- File SEC Form D on or before the anniversary of any previous Form D filing for ongoing offerings

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- Amend state blue sky filings, as applicable

- Complete US Department of Labor filings and deliver venture capital operating company or real estate operating company certifications for Employee Retirement Income Security Act (ERISA) benefit-plan clients or investors, as applicable

- Confirm and comply with any contractual obligations in counterparty agreements, side letters, credit facilities and other documents that require periodic notice, reporting or similar requirements

In addition, CCOs should consider any compliance matters that arose during the previous year, any changes in the investment manager's or its affiliates' business activities, and any changes in applicable law that may require a revision to the compliance program. Documentation of these activities must be kept for a period of five years. CCOs should also coordinate, in conjunction with an investment adviser's senior management, an overall review of the investment adviser's compliance program and adopt any appropriate revisions.

Regulatory Filing Checklist[2]

The following checklist provides a summary chronological listing of certain US Securities and Exchange Commission (SEC), US Commodities Futures Trading Commission, National Futures Association and US Department of the Treasury reporting obligations for the first half of 2016. Many of the deadlines assume a fiscal year end of December 31.

Notable Developments in 2015

Regulators continued to subject private equity firms to heightened scrutiny. The number of SEC enforcement actions increased from 755 in FY 2014 to 807 in FY 2015, with a continued focus on disclosure of conflicts, fees and expenses. Also, 2015 was an active year for rule proposals: the Internal Revenue Service (IRS) and the Treasury's Financial Crimes Enforcement Network (FinCEN) proposed significant new regulations and rules affecting private equity firms, and the SEC proposed changes to investment adviser filing requirements. The following are brief summaries of notable developments relevant to private equity firms with hyperlinks to more detailed information.

- **Conflicts of Interest** – In a February 2015 speech entitled Conflicts, Conflicts Everywhere, the Co-Chief of the SEC's Asset Management Unit (AMU) emphasized that conflicts of interest remain AMU's perennial concern across all investment vehicles. To fulfil fiduciary obligations and avoid enforcement action, she stressed that investment advisers must identify conflicts of interest and then either (i) eliminate them or (ii) mitigate and disclose. (Please see Latham *Client Alert* Multitudes, Multitudes: The SEC's Asset Management Unit Delivers Important Messages for Investment Advisers for a more detailed discussion.) This heightened scrutiny on conflicts and disclosure is exhibited by the number of enforcement actions that the SEC brought in 2015, including these noteworthy actions:

  - *Related Party Transactions* – In November 2015, the SEC settled an enforcement action alleging Fenway Partners LLC, two of its principals, a former principal and the CFO failed to disclose conflicts of interest to a fund client and investors when fund and portfolio company assets were used for payments to an affiliated entity. Fenway Partners entered into management service agreements with certain portfolio companies of the fund under which it received monitoring fees. In accordance with the fund's organization documents, these monitoring fees were offset against the advisory fees the fund paid to Fenway Partners. According to the SEC, beginning in 2011, Fenway Partners caused certain portfolio companies to terminate the management service agreements and enter into consulting agreements with Fenway Consulting Partners, LLC, an affiliate of Fenway Partners, where Fenway Consulting provided similar services to the portfolio companies but the fees paid were not offset against fund advisory fees paid to Fenway Partners. Fenway Partners and its principals agreed to disgorge approximately US$8.7 million and pay penalties totaling approximately US$1.5 million.

  - *Unearned or Inadequately Disclosed Fees* – In October 2015, the SEC settled an enforcement action alleging that three private equity fund advisers within The Blackstone Group failed to fully inform investors about benefits that the advisers obtained from accelerated monitoring fees and discounts on legal fees. Blackstone typically entered into 10-year monitoring agreements with each portfolio company pursuant to which it provided advisory and consulting services for a fee. Before the private sale or initial public offering of certain portfolio companies, Blackstone terminated the monitoring agreements and accelerated the payment of future monitoring fees, including in some instances when monitoring services would no longer be provided. While Blackstone disclosed its ability to collect monitoring fees prior to investors' commitment of capital, it did not disclose its practice of accelerating monitoring fees until after it took the fees. The SEC also alleged that Blackstone failed to disclose a legal fee arrangement providing it with a much greater discount on its legal fees than the discount the funds received, resulting in the funds generating significantly more legal fees than the firm.

  - *Personal Dealings with Clients* – In August 2015, the SEC settled an enforcement action alleging Guggenheim Partners Investment Management LLC failed to disclose a US$50 million loan from an advisory client to an executive. The SEC stated that, after obtaining the loan, the executive

played a role in structuring two transactions in which the client who made the loan received different terms than other advisory clients. The firm agreed to pay a US$20 million penalty.

- *Allocation of Fees and Expenses* – In June 2015, the SEC settled an enforcement action alleging Kohlberg Kravis Roberts & Co. (KKR) misallocated more than US$17 million in "broken deal" expenses and that KKR did not allocate any portion of these broken deal expenses to KKR's co-investors, which included KKR executives, who participated in the firm's private equity transactions and benefited from the firm's deal sourcing efforts. Reflecting the SEC's recent proclivity towards enforcement actions on these issues, the SEC pursued this action even though KKR had determined for itself in late 2011 to create a written policy and allocate broken deal expenses. The SEC also alleged that KKR did not expressly disclose in its fund limited partnership agreements or related offering materials that it did not allocate broken deal expenses to the co-investors. KKR paid nearly US$30 million, including a US$10 million penalty.

- *Outside Business Activities* – In April 2015, the SEC settled an enforcement action alleging BlackRock Advisors LLC failed to disclose a portfolio manager's outside business activity which created a conflict of interest. The SEC stated that, while managing energy-focused funds, a BlackRock portfolio manager founded a family-owned and operated energy company. The SEC found that the company subsequently formed a joint venture with a publicly-traded energy company that became the largest portfolio holding (nearly 10%) of the largest fund he managed at BlackRock. BlackRock agreed to pay a US$12 million penalty.

- *Operating Expenses* – In April 2015, the SEC settled an enforcement action alleging Alpha Titans LLC and two of its executives improperly allocated fund assets to pay undisclosed operating expenses. According to the SEC, Alpha Titans used assets of two affiliated private funds to pay more than US$450,000 in office rent, employee salaries and benefits, and similar expenses without clear authorization from fund clients and without accurate and complete disclosures that fund assets were being used for these purposes. Alpha Titans and its principal agreed to disgorge US$500,000 and pay a penalty of US$200,000.

- **SEC Focus on Implementation of Cybersecurity Controls** – The SEC continues to focus on cybersecurity issues and plans to test and assess firms' cybersecurity controls in 2016. In September 2015, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert announcing the second round of examinations of registered investment advisors (RIAs) as part of its cybersecurity examination initiative. This round will include testing to assess implementation of firm procedures and controls and will focus on six areas:
  - Governance and risk assessment
  - Access rights and controls
  - Data loss prevention controls
  - Vendor management
  - Training programs
  - Incident response plans

  To assist RIAs' compliance with cybersecurity requirements and share where it sees risks, OCIE's risk alert included a sample request for information and documentation. Demonstrating the importance of cybersecurity as a compliance matter, the SEC also settled an enforcement action alleging R.T. Jones Capital Equities Management failed to adopt written policies and procedures reasonably designed to protect customer records and information. According to the SEC, R.T. Jones stored sensitive personally identifiable information (PII) of clients on its third party-hosted web server, which was hacked in 2013. The SEC's order found that R.T. Jones had failed entirely to adopt the

required policies and procedures, including failing to conduct periodic risk assessments, implement a firewall, encrypt PII stored on its server or maintain a response plan for cybersecurity incidents. The firm paid a US$75,000 penalty despite receiving no indications of a client suffering financial harm as a result of the data breach.

- **New Partnership Tax Audit Regime** – The Bipartisan Budget Act of 2015 (the BBA), signed into law in November 2015, significantly changed the US tax audit regime for partnerships. Current audit rules generally require the IRS to allocate a partnership tax liability to, and collect it from, the ultimate partners of the partnership. Effective for taxable years beginning on or after January 1, 2018, partnerships must pay the tax deficiencies (at the highest individual or corporate tax rate in effect for the year under examination) resulting from any audit adjustments, unless the partnership affirmatively elects to pass the adjustments on to its partners. The new rules apply to all partnerships (including limited liability companies taxed as partnerships) with more than 100 partners and to partnerships with 100 or fewer partners if any of the partners is itself a partnership or a trust. Many aspects of these rules, including how the rules will apply to tiered partnerships and how taxes imposed on a partnership with tax-exempt partners may be reduced, are not addressed in the BBA and will have to be addressed in future guidance. The BBA also requires a partnership designate a partnership representative, who need not be a partner but must have a substantial presence in the United States, to assume sole authority to act for the partnership in an audit. (Please see Latham *Client Alert* *New Tax Audit Regime Constitutes a Sea Change for Partnerships* for a more detailed discussion.)

- **IRS Proposed Regulations Addressing Management Fee Waivers** – In July 2015, the IRS proposed regulations regarding when arrangements involving the receipt of a partnership interest for services (*e.g.*, through a waiver of management fees) will be treated as a disguised payment for services (and hence taxed as ordinary income) and not as the right to receive a distributive share of partnership income. The proposed regulations apply a "facts and circumstances" test and provide a non-exclusive list of factors that are relevant to determining whether an arrangement will be treated as a disguised payment for services, identifying the most important factor as whether the arrangement lacks significant entrepreneurial risk. The proposed regulations do not affect traditional forms of carried interest, which are generally subject to a significant entrepreneurial risk. (Please see Latham *Client Alert* *IRS Issues Proposed Regulations Addressing Management Fee Waivers* for a more detailed discussion.)

- **SEC Enforcement Actions Against Compliance Personnel** – In a November 2015 speech, the Director of the SEC's Division of Enforcement addressed concern over SEC enforcement actions against CCOs. He stressed that the SEC carefully weighs bringing actions against CCOs and has only charged a small number for causing violations through wholesale failures in carrying out their compliance responsibilities, namely the development, implementation and annual review of written compliance policies and procedures. For example, in two separate settlements of enforcement actions, the SEC alleged that the CCO caused the compliance failures — even though the CCO was not involved in the actual wrongdoing — by failing to enforce the firm's existing compliance policies.

- **Updated Volcker Rules Interpretations for Foreign Entities** – In February 2015, the Federal Reserve Board issued an FAQ that clarified that non-US banking entities may invest in a covered fund sponsored by an unaffiliated third party even when the unaffiliated third party makes an offering targeting residents of the US. Under the Volcker Rule's exemption for transactions that occur solely outside of the US, or "SOTUS Exemption," non-US banking entities may invest in covered funds (*i.e.*, private equity funds, hedge funds and other private funds) provided, among other conditions, that no offerings target residents of the US. The FAQ explained (i) that the SOTUS Exemption's restriction on

any offering that targets residents of the US does not apply to the activities of third parties unaffiliated with the non-US banking entity, and (ii) that a non-US banking entity that sponsors or serves, directly or indirectly, as the investment manager of a covered fund will be viewed as participating in an offering. Non-US banking entities, however, must still comply with the other restrictions of the SOTUS Exemption. In June 2015, other FAQs clarified that (i) a banking entity may maintain governance, management, investment advisory, service and other relationships with a foreign public fund without the fund's activities being attributed to the banking entity for purposes of the Volcker Rule or the fund being deemed a banking entity itself, so long as the banking entity holds less than 25% of voting shares, and (ii) the joint venture exclusion to the definition of "covered fund" does not include an entity that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

- **FinCEN Proposed AML Rules for Registered Investment Advisers** – In August 2015, FinCEN proposed rules extending the anti-money laundering (AML) requirements of the Bank Secrecy Act (BSA) to RIAs. Under the proposed rules, RIAs will be required to implement written AML programs, file Suspicious Activity Reports and Currency Transaction Reports, comply with the BSA's Recordkeeping and Travel Rules for certain transactions and comply with the USA PATRIOT Act's information sharing requirements. While FinCEN proposed that each RIA tailor its AML program to the specific risks of its advisory services and clients, FinCEN mandated four minimum elements: (i) implementation of policies, procedures and internal controls designed to prevent money laundering or financing terrorist activities; (ii) independent testing by a third party or employees of the RIA or its affiliates (so long as those employees are not involved in the operation and oversight of the AML program); (iii) designation of an individual or committee to be responsible for implementing and monitoring the operations and internal controls of the AML program; and (iv) ongoing AML training for employees, agents and third-party service providers. While the proposed rules did not extend AML requirements to exempt reporting advisers (ERAs), FinCEN requested comment on this issue.

What to Expect in 2016

The SEC is expected to maintain its recent heightened scrutiny of private equity firms, continuing to apply its "broken windows" approach to violations. In the last few years OCIE has hired industry experts, including those focused on private equity, cybersecurity and valuation, and these experts have helped to identify industry-specific issues and risks that have become the focus of recent examinations. In addition, OCIE uses advanced technology to mine data from Form ADV, Form PF and other filings available to the SEC in order to focus on areas of potential risk unique to particular advisers. Moreover, after adding 70 examiners dedicated to investment advisers in 2015, OCIE plans to add another 100 in 2016, bringing its adviser examination staff to approximately 630 examiners. Investment advisers should continue to be prepared for rigorous examinations on these issues:

- **Fees and Expenses** – The SEC is maintaining its focus on private fund advisers' fees and expenses (including disclosure practices, allocation among funds and management company, broken-deal expenses and accelerated monitoring fees). The SEC will evaluate controls and disclosures concerned with simultaneous management of performance-based and asset-based fee accounts. The SEC is closely scrutinizing whether fees are consistent with governing documents and are adequately disclosed. (Please see the Latham-authored article *Fees: Increasing Requirements for Disclosure Continue* for a discussion of the impact on private equity fund advisers.)

- **Focus on Performance Presentations** – Private equity managers should expect the SEC exam staff to scrutinize performance claims in fund marketing materials more closely than in the past. As a result, fund managers should re-evaluate performance disclosures, in particular as to the

transparency of performance calculations. While many private equity firms assume the calculation of prior performance track records is generally consistent among firms, various differences can have material impacts on the calculation of a fund's net return, for example, (i) the inclusion of general partner interests (which generally do not pay a management fee or carried interest), (ii) the inclusion of non-fee paying side-by-side co-investment vehicles, and (iii) the extensive use of lines of credit. Since there is no standard for presenting prior performance in the private equity industry, disclosures of the methods of calculation become increasingly important. Additionally, given the SEC's ongoing Aberrational Performance Inquiry, fund managers should assess whether their reported returns significantly outpace the returns of the fund's peer group, particularly focusing on any reported return series that are consistently two-to-three standard deviations above the peer group. OCIE will likely view such persistent outperformance as suspicious and may target the adviser for an examination and review of the fund's performance calculations (and the valuations driving the performance) at a granular level.

- **Longer, More In-Depth Exams** – Now that the "presence exam" initiative is winding down, the SEC staff is conducting longer, more in-depth and substantive examinations that are focusing on sensitive issues identified during the presence examinations. Private equity firms should expect longer and more thorough examinations that are also more time consuming. In addition, the on-site examination team will commonly include subject-matter specialists and members of the enforcement division.

- **Succession Planning for Investment Advisers** – The SEC is developing recommendations to help advisers assess and plan for the impact on investors when an investment adviser is no longer able to serve its clients. A recent speech by SEC Chair White indicated that the SEC believes these issues should be thought through in advance rather than during the stress of winding down an adviser's operations or transitioning them to another adviser.

- **Proposed Amendments to Form ADV and Recordkeeping Rules** – In May 2015, the SEC proposed changes to Form ADV and the recordkeeping rules applicable to investment advisers. The proposed amendments to Form ADV would: (i) require aggregate information related to assets held and use of borrowings and derivatives in separately managed accounts; (ii) codify "umbrella registration" filing arrangements that are currently outlined in staff guidance; and (iii) require additional information about an investment adviser's advisory business, including branch office operations, the use of social media and whether the CCO is compensated or employed by a third party. As proposed, the additional information provided on Form ADV would be available to the general public. The proposed amendments to the recordkeeping rules would require investment advisers to maintain records of the calculation of performance or rate of return that is distributed to *any* person (instead of the current rule, which requires records of distributions to 10 or more persons). The rules would also require investment advisers to maintain originals of all communications received and copies of all communications sent related to performance or rate of return of accounts and securities recommendations.

- **Stress Tests for Large Investment Advisers** – The SEC is considering ways to implement the requirements under the Dodd-Frank Act that large RIAs and registered funds conduct annual stress testing and liquidity risk management. In an October 2015 speech, SEC Chair White discussed that while the initial focus is on registered funds and their advisers, the SEC is also exploring the issue for other RIAs with US$10 billion or more in consolidated assets, including private fund advisers. The SEC recognizes the challenge in tailoring stress tests to the specific risks and business models of diverse asset managers and concedes that traditional models of stress testing for banks and broker-dealers may not be transferrable.

Wrap Up

The SEC remains particularly focused on compliance related to investment funds and investment managers. CCOs should also keep abreast of current trends, as described in SEC speeches, notices, and enforcement actions and continually adjust their compliance program appropriately to address such developments. The SEC may raise the issues described above during any examination. Investment managers should also anticipate investors inquiring about these issues. Long-standing practices may be exposed to new scrutiny. As a result, investment managers should examine their current disclosures for fees, expenses and performance reporting to confirm that their practices match the disclosures and prepare for further transparency initiatives from the SEC.

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Endnotes

[1] Financial institutions (including private funds and RIAs) are no longer required to provide an annual privacy notice, pursuant to the 2015 Fixing America's Surface Transportation (FAST) Act, if two conditions are met: (i) the financial institution only disclosed nonpublic personal information (NPI) to a nonaffiliated third party in a manner that did not trigger an opt-out right for consumers under Gramm-Leach-Bliley Act, and (ii) the financial institution has not changed its policies and practices with regard to disclosing NPI from the policies and practices that were last sent to its consumers.

[2] Does not address filing obligations for registered CPOs or CTAs.