Private Funds Year in Review and 2017 Outlook

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In 2016, the U.S. Securities and Exchange Commission (SEC) continued its regulatory focus on private funds. The SEC investigated and brought cases related to staple issues such as disclosure failures and Foreign Corrupt Practices Act violations, and extended into areas such as cybersecurity and valuation. As 2017 gets off the ground, complete with the uncertainty inherent with a new administration, private funds naturally wonder about the future of the recently-robust enforcement environment. It is ever more important for private fund advisers to continue to update and improve their compliance infrastructure and to evaluate their internal policies and procedures.

Last year marked a new SEC single-year high for overall enforcement actions, including eight separate cases brought against private equity advisors, an increase over 2015's three cases. Former Chair Mary Jo White attributed the SEC's overall success to its three-year-long focus on increasing the Commission's use of technology practices and "big data" in its enforcement approach. The evolving techniques allowed the SEC to expand its reach, evidenced by the various new and novel actions undertaken by the SEC in the past year. Among the 2016 actions of first impression, the SEC brought charges against a private equity adviser for acting as an unregistered broker.

While 2016 continued the SEC's upward trajectory of enforcement trends, it remains unclear whether those trends will continue in 2017. Shortly after November's election, White announced that she would be stepping down despite having more than two years left in her tenure. President Trump has nominated Sullivan & Cromwell partner Jay Clayton to replace White as SEC Chairman. In contrast to White, who was a well-known federal prosecutor prior to her law firm and SEC tenures, Clayton, who specializes in M&A and capital-raising efforts, has been characterized by some as a "friend to Wall Street." Some commentators believe he may represent a significant shift from the prosecutorial-minded White—hypothesizing that the combination of President Trump's anti-regulatory bent and Clayton's transactional nature will result in a rolling back of certain enforcement directives seen by conservative lawmakers as harmful to business. By contrast, recently-resigned SEC Enforcement Director Andrew Ceresney, another former federal prosecutor, predicted that the SEC's overall aggressiveness under White would continue with Clayton at the helm and that White's "aggressive, tough, but fair" approach will be a model to follow in the coming years. Time will tell.

We summarize below a few noteworthy issues and enforcement trends of 2016 and provide an outlook for 2017.

SEC Enforcement Results for 2016

Scrutiny of Private Funds

Since the SEC's creation of specialized Asset Management Units in 2010 (as a result of Dodd-Frank), the Commission has evolved its understanding and enforcement of private fund advisers and firms. In 2012, the Commission launched the Office of Compliance, Inspections, and Examinations (OCIE), which subsequently created its own Private Funds Unit. In both 2015 and 2016, PE funds were put on notice by OCIE's stated exam priorities, which indicated higher attention from the SEC to the "rate of deficiencies" observed among fund advisers in connection with fees and expenses. OCIE's 2016 approach included more attention to hedge funds, including the directive to maintaining a focus on fees and expenses and evaluating, among other things, various controls and disclosure obligations. In his May 12, 2016 speech, Ceresney observed that over 50 percent of the examined PE fund advisers had compliance problems—including allocation of expenses, hidden fees, disclosures and issues relating to valuation. He noted current enforcement actions and stated that there were "more to come."

Disclosure Failures

PageOne Financial. On May 27, 2016, the Commission issued a cease-and-desist proceeding opinion against Edgar Page, the chairman and principle of PageOne Financial, Inc. Page was charged with directing clients to invest in several private funds established by a real estate development and management company without disclosing that he was seeking an investment deal with the company. Part of the deal required Page to help the private funds raise $20 million. For two and a half years Page directed his clients to invest between $13-15 million in the funds. PageOne received $2.7 million of those investments. The SEC charged Page under the Investment Advisers Act, and Page was ordered to disgorge $2.18 million, had his investment adviser registration revoked, and received a five-year securities ban.

WL Ross & Co. On August 24, 2016, the SEC settled with PE firm WL Ross & Co. over disclosures of fee allocation practices, with WL Ross voluntarily reimbursing approximately $11.8 million to certain WL Ross funds and paying a $2.3 million penalty. Among other things, the SEC alleged that the firm's limited partnership agreements were ambiguous concerning fee offsets in situations where ownership was shared by multiple funds and other co-investors. WL Ross voluntarily adopted new ways to allocate fees and the SEC noted their cooperation in self-reporting of the issue.

Conflict of Interest

First Reserve. On September 14, 2016, the SEC settled with PE firm First Reserve Management LP for $3.5 million, alleging that the group failed to disclose certain conflicts of interest to investors. First Reserve allegedly negotiated for its own benefit a legal fee discount from a law firm based in large part on the volume of work the law firm was performing for the funds, but did not negotiate such discount for the funds themselves, and failed to properly allocated D&O insurance expenses between itself and its managed funds. Additionally, First Reserve allegedly failed to disclose a financial conflict of interest arising from certain administrative and investment advisory expenses charged to a portfolio company that was a pooled investment vehicle with a separate investment adviser.

Unregistered Broker-Dealer

Blackstreet. For the first time, the SEC charged a PE adviser for failing to register as a broker-dealer. On June 1, 2016, the SEC settled with Blackstreet Capital Management for $3.1 million, alleging that the adviser engaged in brokerage activity and received fees without registering. Blackstreet disclosed to its clients and investors that it was providing brokerage services in exchange for fees, but failed to adequately register. Blackstreet also allegedly charged fees to portfolio companies in one fund for providing operating partner oversight, but the fund's limited partnership agreement did not disclose that Blackstreet received such fees, resulting in a conflict of interest because Blackstreet used fund assets to compensate itself.

Gatekeeper Failures

Apex Fund. On June 16, 2016, the SEC—which has made an overall effort to hold gatekeepers accountable in ensuring their clients follow the securities laws—alleged that Apex Fund Services (US) Inc. failed to acknowledge red flags and correct faulty accounting by clients. The fund allegedly "missed or ignored clear indications of fraud while contracted to keep records and prepare financial statements and investor account statements." The SEC faulted the fund administrators and cautioned that "[f]und administrators are responsible for ensuring that fund records provide accurate information about the value and existence of fund assets." Apex agreed to a $352,449 settlement.

FCPA Violations

Och-Ziff. The Foreign Corrupt Practices Act (FCPA) continues to be an issue of focus for the SEC, including for private funds. On September 29, 2016, the SEC settled with Och-Ziff Capital Management Group for $200 million in civil penalties resulting from the firm's practices in securing investments from overseas sovereign wealth funds. According to the SEC, Och-Ziff used intermediaries, agents, and business partners to bribe government officials in Africa so that the officials would direct government sovereign wealth funds to invest in Och-Ziff managed funds. The scheme was conducted in at least five African countries. Och-Ziff was also charged with failing to maintain accurate books and records relating to the payments. In addition to the civil penalties, the firm acknowledged that it would enter into a deferred prosecution agreement and pay a criminal penalty of $213 million. The firm's CEO also agreed to a $2.2 million penalty, and on January 26, 2017, the SEC charged the firm's European office head and the investment executive on Africa deals for being the masterminds behind the bribery scheme.

2017 Outlook

Cybersecurity Remains a Priority

In publishing its examination priorities and in other public statements, the SEC repeatedly has made clear that cybersecurity will continue to be a priority for private fund advisers in 2017 and beyond. OCIE's Cybersecurity Examination Initiative is designed to build on its previous exams and guidance to ensure preparedness in the securities industry and protect client information—focusing on governance and risk assessment, access rights and controls (preventing unauthorized access to systems or information), data loss prevention, and vendor management (i.e., hacking of third-party vendor platforms), training of employees, and incident response policies and procedures. The SEC has urged advisers to focus on operational risks and the importance of designing and implementing adequate written policies and procedures designed to protect customer or investor records and information.

Financial Crimes Enforcement Network

In addition to a reasonable probability that the SEC will continue its aggressive enforcement actions, private fund advisers should be aware of the Financial Crimes Enforcement Network (FinCEN)'s proposed rules which would, for the first time, require private funds registered with the SEC to establish Anti-Money-Laundering programs and report suspicious activity under the Bank Secrecy Act. FinCEN's proposal would delegate enforcement of the rules to the SEC. The rule could still undergo revision before being finalized by FinCEN, so the earliest it could go into effect is mid-2016. The rules include the requirement to establish an AML program that includes written policies and procedures, designation of a qualified AML officer or committee, personnel training, and independent compliance testing. In addition, any activity that appears suspicious—particularly with regard to money-laundering or terrorism—will have to be reported to FinCEN within 30 days of the activity.

Top Compliance Issues for Advisers

The SEC recently published a risk alert detailing the five most frequent compliance issues identified by OCIE in examinations of investment advisers. The alert reflects issues addressed in over 1,000 investment adviser examinations over the past two years and gives advisers and funds clear guidelines about what OCIE looks for when addressing the most common deficiency concerns. The most common issues include the failure to follow compliance guidelines, deficient regulatory filings, failure to follow the Custody Rule when advising on customer accounts, violating the Code of Ethics Rule, and non-compliance with the Books and Records Rule. While the Alert did not reveal particularly novel issues, it serves as a reminder that it remains critical for advisers to stay vigilant when assessing risk and not overlook the staple regulatory compliance mechanisms.

Conclusion

In all, 2016 was marked by the SEC's continued pressing of private funds to ensure that they accurately and completely disclosed information, particularly about conflicts of interest, to their limited partners—taking the view that advisers have a duty to identify all conflicts and either eliminate or disclose them. The SEC's actions serve as a reminder for private fund advisers to review and revise, as necessary, their policies and procedures, ever mindful of creating a culture of compliance to ensure the rights of investors are protected.