Private Equity Regulatory Update

July 31, 2018

Rules and Regulations

SEC Proposes Whistleblower Rule Amendments

On June 28, 2018, the SEC voted to propose amendments to the rules governing its whistleblower program. The proposed changes include expanding the types of resolutions covered by the program, giving the SEC discretion in modifying awards, eliminating potential double recoveries, adjusting the claims review process, and barring individuals who submit false information or make repeated frivolous claims. The proposed amendments would also expressly adopt the reporting requirements set forth in Digital Realty Trust, Inc. v. Somers, a recent Supreme Court decision which held that Dodd-Frank whistleblower protections apply only when a securities-law violation is reported to the SEC. For further discussion of the proposed amendments, please see the July 6, 2018 Davis Polk Client Memorandum, **SEC's Proposed Amendments to Its Whistleblower Program May Increase Reporting of Potential Securities-Law Violations to the SEC**.

Industry Update

SEC Releases Strategic Plan for Fiscal Years 2018–2022

On June 19, 2018, the SEC released its draft proposed strategic plan for fiscal years 2018 through 2022 (the "**Strategic Plan**"). According to the Strategic Plan, the SEC has three main goals: first, to improve its focus on the long-term interests of "Main Street" investors; second, to recognize the significant developments in the evolving capital markets and to effectively allocate the SEC's resources; and third, to enhance the agency's analytical capabilities and development of human capital.

With regard to the first goal, the Strategic Plan notes that the SEC would like to improve its understanding of how Main Street investors use and interact with the capital markets in order to better tailor its educational and outreach efforts. According to the Strategic Plan, the agency will focus on enforcement and examination initiatives that aim to protect retail investors. It will focus on modernizing disclosure

requirements, including the "design, delivery, and content," so that this information is more accessible and comprehensible for Main Street investors. The Strategic Plan also states that the SEC will try to identify ways to increase the number of investment options that are suitable for, and available to, these Main Street investors.

The second goal of the SEC is a focus on technological developments and their impact on the capital markets. The SEC will work to update rules and procedures in light of new technology and marketplace operations, as well as focus on risks that arise from these new technological developments (e.g., cybersecurity). According to the Strategic Plan, the SEC will also try to better identify and understand market developments, and, in light of these, replace outdated procedures that are not "functioning as intended." The SEC will review and update, where necessary, its emergency response capabilities and will provide regular training and testing.

Lastly, the third goal of the Strategic Plan is aimed at enhancing the SEC's analytics and development of human capital. According to the Strategic Plan, the SEC will focus internally on promoting diversity, inclusion and equal opportunities among its staff. The Strategic Plan notes that the SEC will also develop a data management system which "treats data as an SEC-wide resource with appropriate data protections," and enhance its use of analytics. The SEC also intends to further develop its internal controls and risk management capabilities in order to better protect against security threats. The Strategic Plan also states that the SEC intends to promote collaboration and communication both within and across different offices and will reevaluate internal processes in order to enhance staff collaboration.

The Strategic Plan was prepared according to the Government Performance and Results Modernization Act of 2010, pursuant to which federal agencies must outline their strategic goals for each four-year period. The SEC released the Strategic Plan to the public and welcomes comments and feedback.

- **See the SEC Strategic Plan**

Litigation

SEC Charges New York-based Investment Adviser for Failing to Disclose Conflicts of Interest Related to Compensation Obtained from Third Parties

On June 4, 2018, the SEC issued an order (the "**DVU Order**") against deVere USA, Inc. ("**DVU**"), a New York-based investment adviser, instituting and settling administrative and cease-and-desist proceedings for failing to disclose to its clients and prospective clients conflicts of interest regarding compensation obtained from third-party product and service providers.

According to the DVU Order, DVU provided investment advice to its clients, who were primarily U.S. residents or citizens with U.K. pensions, in connection with transferring their U.K. pension assets to certain overseas retirement plans for which DVU would provide ongoing investment advice. When DVU clients transferred their funds to the plans recommended by DVU and its representatives, the third-party firms charged the clients a fee. Half of the fee was then paid to the DVU representative that made the recommendation. DVU also recommended that certain clients convert their U.K. pensions to other currencies; DVU received a portion of the fees that third-party foreign exchange providers received for the conversion. The SEC alleged that, between June 2013 and March 2016, DVU failed to disclose to its clients that its representatives would receive payments from the firms to which DVU's clients transferred their assets or used for currency conversion, and that the undisclosed compensation was the primary form of compensation that DVU's representatives received for their advisory services.

In addition to the allegations relating to DVU's failure to disclose conflicts of interest, the SEC also alleged that DVU investment adviser representatives made materially misleading statements concerning the benefits of transferring U.K. pension assets to one of these overseas retirement plans.

The DVU Order also states that DVU failed to tailor its compliance policies to its actual business by failing to address the conflicts of interest posed by receiving compensation from the third parties with whom it recommended that its clients do business.

Based on the conduct described above, the SEC alleged that DVU willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Section 207 of the Advisers Act, which prohibits any person from willfully making misstatements or omissions of material fact in any registration application or report filed with the SEC. Additionally, the SEC alleged that DVU also willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require, among other things, that a registered investment adviser adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons.

DVU consented to the entry of the DVU Order without admitting or denying the findings and agreed to be censured, to cease and desist, and to pay a civil money penalty in the amount of $8 million. In addition, DVU agreed to comply with its disclosure obligations under the Advisers Act, provide training to DVU employees, and retain an independent compliance consultant.

The DVU Order emphasizes the SEC's continued focus on failures to disclose conflicts of interest arising from compensation received by investment advisers from third parties, as well as the importance of ensuring that compliance policies and procedures are reviewed and revised in light of a firm's business.

- **See a copy of the DVU Order**

SEC Charges Fund Managers for Failing to Offset Portfolio Company Fees, Disclosures Regarding Accelerated Fees

Since 2014, the SEC has charged a number of venture capital and private equity firms for failing to adequately disclose the practice of receiving accelerated consulting or management fees upon the sale or initial public offering of a portfolio company, or for failing to credit or offset such fees as disclosed in the fund's governing documents.[1] While the frequency of such settlements has decreased, on June 29, 2018, the SEC issued two such orders, one against Aisling Capital LLC (the "**Aisling Order**") and one against THL Managers V, LLC and THL Managers VI, LLC (the "**THL Order**"). These orders underscore that the SEC continues to require advisers to disclose any potential conflicts of interest before investors commit capital, and that advisers should ensure that they are following their disclosed fee allocation practices.

The Aisling Order

According to the Aisling Order, Aisling Capital LLC ("**Aisling**") provided investment advisory services to two venture capital funds that made investments in life sciences companies. Under the funds' governing documents, Aisling may receive fees, such as transaction fees or consulting fees, from portfolio companies, and is required to offset 50% or 70% (depending on the fund) of the fees received against the management fee that the funds pay Aisling.

The Aisling Order alleges that from 2008 to 2013, Aisling received more than $2.3 million in consulting fees from certain fund portfolio companies and failed to offset these amounts against Aisling's management fees, causing the funds to pay approximately $760,000 more in management fees than they would have paid had Aisling offset the fees.

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[1] *See generally*, ***Leor Landa & James H.R. Windels, Allocating Fees and Expenses: The SEC is Paying Close Attention*, 5 Int'l Comp. Legal Guide to Alternative Inv. (2017)**.

After the SEC's Enforcement Division contacted Aisling in January 2017, Aisling voluntarily reimbursed the funds' investors for the entirety of the management fees that should have been offset, plus interest. Aisling also named a new chief compliance officer and implemented new controls to ensure the accurate calculation of management fee offsets.

The SEC charged Aisling with violations of Section 206(2) and 206(4) of the Advisers Act, and ordered Aisling to pay a civil penalty of $200,000.

The THL Order

The THL Order alleges that in 2000 and 2006, THL Managers V, LLC and THL Managers VI, LLC (together, "**THL**") launched two THL-managed private equity funds without adequately disclosing that THL might receive "lump sum" management fees from fund portfolio companies. THL typically entered into agreements with portfolio companies under which THL received periodic fees in exchange for providing certain services to the companies; under some of these agreements, THL would receive an accelerated, lump sum of future fees upon a sale or IPO of the portfolio company.
The SEC notes that the relevant THL funds' disclosures stated that THL entered into agreements with, and received fees from, portfolio companies, and that a majority percentage of such fees would be offset against management fees while THL retained the remainder. In addition, for one of the funds, THL entered into side letters with "more than three quarters" of the fund's investors stating that THL may receive fees upon the sale or IPO of a portfolio company. THL also disclosed the amount of accelerated fees in its semiannual reports to all investors.

The SEC nonetheless asserted that THL did not adequately disclose to all limited partners "prior to their commitment of capital" that THL may receive accelerated fees, and that the receipt of such fees created "at least a potential conflict of interest" between THL and the funds. Because this potential conflict was not disclosed before capital was committed, the SEC states, THL could not consent to the potential conflict, and thereby "negligently breached" its fiduciary duties under Section 206(2) of the Advisers Act. The THL Order notes that THL cooperated with the Staff's investigation, but does not identify any remedial measures undertaken during the investigation. THL agreed to pay disgorgement of $4,806,016 (including $200,000 in prejudgment interest) to investors, as well as a civil penalty of $1.5 million.

- **See a copy of the Aisling Order**
- **See a copy of the THL Order**

SEC Charges a Financial Institution with Failure to Detect or Prevent Misappropriation of Client Funds

On June 29, 2018, the SEC issued an order (the "**Order**") against a financial institution instituting and settling administrative and cease-and-desist proceedings for failing to protect against misappropriation of client funds by personnel of the financial institution.

According to the Order, from at least 2009 to the present, the financial institution permitted its investment adviser representatives and registered representatives, which the financial institution referred to as "financial advisors," to initiate third-party disbursements from client accounts of up to $100,000 per day per account based on an attestation by financial advisors that he or she had received a verbal request from the client. The SEC alleged that, while the financial institution provided for certain reviews of disbursement requests, such reviews were not reasonably designed to detect or prevent such misconduct.

The SEC claimed that the financial institution's insufficient policies and procedures contributed to its failure to detect or prevent one financial advisor from misappropriating funds from client accounts for a period of nearly one year. According to the Order, from December 2015 until November 2016, this

financial advisor allegedly initiated $7 million in unauthorized transactions out of his clients' accounts and, through these unauthorized transactions, misappropriated over $5 million.

According to the Order, in November 2016, a representative of the defrauded clients contacted the financial institution concerning the transactions in their accounts. As the Order notes, the financial institution promptly conducted an internal investigation, terminated the financial adviser involved in the misappropriation, and reported the fraud to the SEC and other law enforcement agencies. The Order further states that the financial institution entered into settlement agreements with the defrauded clients in which it fully repaid the clients plus interest. Additionally, according to the Order, the financial institution developed significant enhancements to its policies, procedures, systems and controls relating to preventing or detecting conversion of third-party cash disbursements from client funds, increased its anti-fraud program expenditures, and hired additional fraud operations personnel.

As a result of the conduct described above, the SEC charged the financial institution with willfully violating Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require, among other things, that a registered investment adviser adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons. The SEC also charged the financial institution for failing to reasonably supervise one of its financial advisors within the meaning of Section 203(e)(6) of the Advisers Act.

Without admitting or denying the findings, the financial institution consented to the entry of the Order and agreed to be censured, to cease and desist, made undertakings related to the firm's policies and procedures and to pay a civil money penalty in the amount of $3.6 million.

The Order highlights the SEC's willingness to charge financial institutions offering investment advisory services for failing to prevent the misconduct of their investment advisory personnel.

- **See a copy of the Order**

Davis Polk

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