Private Equity Regulatory Update

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Industry Update

SEC Announces Cybersecurity Enforcement Initiatives

On September 25, 2017, the SEC issued a press release announcing two new initiatives to further ongoing cyber-related enforcement efforts: (i) a Cyber Unit that will focus on targeting cyber-related misconduct and (ii) a Retail Strategy Task Force that will implement initiatives directly affecting retail investors.

According to the press release, the Cyber Unit will include staff from across the SEC's Enforcement Division and will target cyber-related misconduct such as market manipulation schemes conducted via electronic and social media, hacking to obtain material nonpublic information, violations involving initial coin offerings and threats to critical market infrastructure.

According to the press release, the Retail Strategy Task Force will leverage technology and data analytics from past enforcement actions to develop initiatives aimed at identifying large-scale misconduct that impacts retail investors.

- **See a copy of the Press Release**

SEC Chairman Issues Statement on Cybersecurity

On September 20, 2017, SEC Chairman Jay Clayton released a public statement (the "**Statement**") outlining the SEC's approach to identifying and managing cybersecurity risks.

Clayton began by discussing the three types of data the SEC collects: (i) public-facing data, which is transmitted to and accessed through SEC systems such as EDGAR; (ii) nonpublic data related to issuers, broker-dealers, investment advisers, investment companies and other market participants, which is collected in connection with the SEC's ongoing supervisory and enforcement functions; and (iii) nonpublic data related to the SEC's internal operations, which include records of internal investigations, risk management data and internal memoranda, among other things.

Next, Clayton described the cybersecurity risks faced by the SEC, including risks of external cyber threat actors compromising EDGAR user credentials, making fraudulent filings and accessing nonpublic data on enforcement actions and illegally profiting from them. Further, Clayton pointed to potential unauthorized

actions or disclosures by SEC personnel and weaknesses in third-party vendor systems. To combat these threats, Clayton outlined an agency-wide cybersecurity program that includes the following key aspects:

- *Governance*. Clayton noted that SEC commissioners and senior management are required to coordinate their cybersecurity efforts through risk reporting and the development and testing of agency-wide procedures. The SEC Office of Information Technology has overall management responsibility for the cybersecurity program, which is periodically assessed internally and by impartial third parties.
- *Policies and procedures*. According to Clayton, the SEC has established internal cybersecurity policies and procedures that detail the roles and responsibilities of various SEC officials, offices, committees and system owners. The SEC is also in the process of implementing the National Institute of Standards and Technology's Framework for Improving Critical Infrastructure Cybersecurity.
- *Independent audits and reviews*. According to Clayton, the SEC's cybersecurity program is also periodically reviewed by internal and external independent auditors, including the Office of Inspector General and the Government Accountability Office.
- *External reporting*. According to Clayton, the SEC has established protocols for submitting cybersecurity performance reports to the Office of Management and Budget, and privacy and cybersecurity incidence reports to the Department of Homeland Security. Information on cybersecurity is also shared with other external institutions such as the National Cybersecurity and Communications Integration Center and the Financial and Banking Information Infrastructure Committee.

Clayton then focused on the SEC's efforts to incorporate cybersecurity considerations into its existing disclosure and supervisory programs. According to Clayton, these efforts include:

- *Guidance on effective public company disclosures*. Clayton noted that as the SEC's primary role in regulating U.S. public company issuers is disclosure-based, the Division of Corporation Finance has issued guidance aimed at helping companies consider how cybersecurity disclosures should be included in their public reports. Such guidance includes a discussion of cybersecurity considerations relevant to a company's risk factors, management's discussion and analysis of financial condition and results of operations, description of business, discussion of legal proceedings, financial statements and disclosure controls and procedures.
- *Oversight of market infrastructure*. According to Clayton, in an effort to bolster the technology infrastructure of U.S. securities markets, the SEC adopted in 2014 Regulation Systems Compliance and Integrity and Form SCI, which require "SCI entities" (including self-regulatory organizations such as stock and options exchanges, certain alternative trading systems, disseminators of consolidated market data and certain exempt clearing agencies) to (i) maintain policies and procedures reasonably designed to ensure operational resiliency and (ii) take corrective action and notify the SEC when system disruptions, compliance issues and intrusions such as cybersecurity breaches occur. In addition, SCI entities are subject to examination by the Office of Compliance Inspections and Examinations ("**OCIE**").
- *Oversight of market participants*. According to Clayton, the SEC has issued a number of regulations that directly implicate cybersecurity practices in regulated entities such as broker-dealers, investment advisers, investment companies, credit rating agencies and other market participants. Such regulations include Regulation S-P, which requires registered broker-dealers, investment companies and investment advisers to adopt written policies and procedures to facilitate the protection of customer information and records, as well as Regulation S-ID, which requires the same firms to establish programs aimed at identifying, detecting and responding to potential identity theft red flags for certain covered accounts. Clayton further noted that

compliance with the foregoing regulations has been a focus of OCIE examinations of registered entities.

With respect to broad and potentially systemic cybersecurity risks, Clayton noted the SEC's focus on coordinating with other U.S. and non-U.S. regulatory agencies that share oversight responsibilities. Clayton also warned that failure by market participants to take their cybersecurity obligations seriously may result in enforcement actions, as the SEC is not limited to using its enforcement authority against those engaging in illegal cyber activity.

- **See a copy of the Statement**

ESG in Private Equity: What Every GP Needs to Know About Public Pension Fund Requirements

Public pension funds have long been outspoken advocates of environmental, social and governance ("**ESG**") principles in investing. As quasi-public institutions uniquely sensitive to public opinion and the political process, public pension funds have begun to incorporate ESG considerations into all asset classes in their portfolio, including their private equity investments. With public pension fund limited partner ("**LP**") investments constituting 44% of total worldwide private funding by the top 100 LPs in private equity—the largest category of private equity LP type by far among the top 100—it is important that private equity firms understand the ESG expectations of public pension funds and assess on an ongoing basis whether their ESG policies and practices, and those of their portfolio companies, are responsive.

In a **recent memo**, we review ten North American public pension funds with some of the largest stakes in private equity and describe how public pension funds integrate their ESG policies in LP investments with private equity funds.

Litigation

SEC Charges Private Equity Fund Adviser and Principal for Improper Allocation of Expenses

On September 11, 2017, the SEC issued an order (the "**PAMCO Order**") instituting and settling administrative and cease-and-desist proceedings against Potomac Asset Management Company Inc., an investment adviser registered with the SEC ("**PAMCO**") and Goodloe E. Byron, Jr., its principal ("**Byron**" and, together with PAMCO, the "**PAMCO Parties**") for improperly allocating certain fees and expenses to two private equity fund clients, Potomac Energy Fund, L.P. ("**Fund I**") and Potomac Energy Fund II, L.P. ("**Fund II**" and, together with Fund I, the "**Funds**").

According to the PAMCO Order, PAMCO provides investment advisory and management services to the Funds. The Funds' limited partnership agreements ("**LPAs**") provided that PAMCO would be responsible for paying its own operating expenses, including overhead, employee compensation, office rent and regulatory expenses. In addition, the LPAs stated that while PAMCO was entitled to receive an annual management fee from the Funds, such management fee would be offset by a specified percentage of PAMCO's other income, including consulting and other fees received from portfolio companies.

According to the PAMCO Order, between 2012 and 2013, the PAMCO Parties improperly allocated to Fund I $2.2 million in fees for services to a portfolio company without authorization to do so in the LPAs, and failed to disclose the misuse of fund assets to Fund I's limited partners. Further, the PAMCO Order alleged that after the relevant portfolio company reimbursed these fees, PAMCO failed to offset the fees against management fees in accordance with the LPA, which resulted in PAMCO collecting $726,000 more than it should have received. In addition, the PAMCO Order alleged that between 2012 and 2015,

the PAMCO Parties improperly used the Funds' assets to pay $703,835 in adviser-related expenses, which was expressly prohibited by the LPAs. These expenses included compensation to a member of PAMCO's investment team, office rent and operational expenses, and costs incurred during examinations by the OCIE and the SEC's Enforcement Division. According to the PAMCO Order, PAMCO's Form ADV for 2012 through 2014 failed to disclose that these expenses had been charged to the Funds.

According to the PAMCO Order, PAMCO also failed to disclose the transactions described above, which constitute related party transactions for purposes of GAAP, in the Funds' audited financial statements. As a result, such financial statements were not prepared in accordance with GAAP and PAMCO, which had custody of client assets as an investment adviser, was not entitled to rely on Rule 206(4)-2(b)(4) of the Advisers Act, which provides a limited exception to Rule 206(4)-2 (the "**Custody Rule**") for advisers to pooled investment vehicles that provide limited partners with GAAP-compliant financial statements within 120 days of the end of each fiscal year. According to the PAMCO Order, the Funds' audited financial statements also failed to be compliant with the Custody Rule because they were not distributed to the Funds' partners within the required 120-day period.

Finally, according to the PAMCO Order, the SEC found that PAMCO failed to implement written policies and procedures to prevent violations of the Advisers Act. The PAMCO Order alleged that, from 2012 to 2014, PAMCO's compliance manual did not include policies and procedures that addressed allocation of expenses between PAMCO and the Funds, Byron's control of related parties and how that control might affect related party transactions, and required disclosures. Moreover, according to the PAMCO Order, Byron, as the owner and controlling person of the general partner of both Funds, failed to make timely capital contributions to the Funds as required under the LPAs, which failure was not adequately disclosed to the Funds' limited partners.

According to the PAMCO Order, as a result of the conduct described above, the PAMCO Parties willfully violated (i) Section 206(2) of the Advisers Act; (ii) Section 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder, which make it unlawful for any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statement made not misleading or to engage in any fraudulent, deceptive or manipulative act with respect to any investor or prospective in the pooled investment vehicle; (iii) Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder and (iv) the Custody Rule.

The PAMCO Parties consented to the entry of the PAMCO Order without admitting or denying the findings and agreed to pay a civil money penalty of $300,000. The PAMCO Order noted that the SEC considered remedial acts undertaken by PAMCO, including voluntarily reimbursing the Funds for the improperly allocated expenses and excess management fees discussed above (including interest), hiring a new Chief Compliance Officer and engaging an independent compliance consultant, in accepting the offer of settlement.

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

SEC Charges Investment Adviser with Disclosure Failures Relating to 'Broken Deal' Expenses

On September 21, 2017, the SEC issued an order (the "**Platinum Order**") instituting and settling administrative and cease-and-desist proceedings against Platinum Equity Advisors, LLC, an investment adviser registered with the SEC ("**Platinum**") for causing its three main private equity funds (the "**Platinum Funds**") to bear broken deal expenses that benefited co-investors without disclosing to fund investors that they would bear co-investors' expenses.

Like many private equity funds, co-investors—according to the Platinum Order, "typically officers, directors, executives, and employees of Platinum"—invested alongside the Platinum Funds. The limited partnership agreements of the Platinum Funds required that each fund "bear and be charged with all expenses of the [p]artnership other than [g]eneral [p]artner [e]xpenses." The Platinum Funds' private

placement memoranda stated that each fund would "pay all expenses related to its own operations." The limited partnership agreements and private placement memoranda did not disclose that Platinum Funds would bear broken deal expenses for the portions of investments that would have been allocated to co-investors.

According to the Platinum Order, from 2004 to 2015, the Platinum Funds invested $5.3 billion in 85 companies. Over the same period, co-investors invested approximately $728 million in these same companies through Platinum-managed co-investment vehicles. The Platinum Order alleged that despite the incurrence of significant broken deal fees and the absence of disclosure stating that all broken deal expenses would be borne by the Platinum Funds, Platinum did not allocate any broken deal expenses to its co-investors, which had also participated in Platinum's successful transactions. According to the Platinum Order, this resulted in the Platinum Funds being allocated $1,811,501 more in broken deal expenses from Q2 2012 to 2015 than they should have. Further, according to the Platinum Order, Platinum's allocation of broken deal expenses benefiting co-investors affiliated with Platinum also operated as an undisclosed conflict of interest between Platinum and the investors in the Platinum Funds. Finally, the Platinum Order stated that Platinum had failed to adopt and implement a written compliance policy or procedure governing the allocation of broken deal expenses.

According to the Platinum Order, as a result of the conduct described above, Platinum violated (i) Section 206(2) of the Advisers Act and (ii) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Platinum consented to the entry of the Platinum Order without admitting or denying the findings and agreed to pay a total of $1,902,132, consisting of $1,708,388 in disgorgement and $193,744 in prejudgment interest, as well as a $1.5 million civil money penalty.

The Platinum Order highlights three key points for private equity advisers:

- First, it is clear that the SEC remains focused on situations presenting potential or actual conflicts of interest between private equity advisers and the investors in their managed funds. Numerous enforcement actions over the past three years demonstrate that the SEC will carefully scrutinize an adviser's allocations of investments, fees, and expenses and take remedial action when the SEC staff believes that the adviser may have acted contrary to investors' best interests.
- Second, in light of these settlements, private equity advisers should (i) adequately disclose to prospective investors potential conflicts of interest, including how fees, expenses, and benefits will be allocated among managed funds, the manager, and any co-investors; and (ii) adopt precisely described policies and procedures regarding investment, fee, and expense allocation, and ensure that the policies are followed through a robust compliance program.
- Third, the Platinum Order notably does not indicate that Platinum discovered the allocation issue on its own initiative, or made efforts to remedy the misallocation (for example, by refunding the funds for the co-investors' portion of expenses). The penalty Platinum agreed to pay is about 79% of the total amount disgorged, which is somewhat higher than average and notably higher than other enforcement actions in which the charged adviser voluntarily refunded investors the amount that the SEC believed to have been misallocated.

► **See a copy of the Platinum Order**

SEC Brings Action Against Two Companies Related to Initial Coin Offerings

On September 29, 2017, the SEC filed **a complaint** in federal court against REcoin Group Foundation, LLC ("**REcoin**"); DRC World, Inc., also known as Diamond Reserve Club ("**DRC**"); and their principal, Maksim Zaslavskiy. The complaint alleges false and misleading statements and violations of securities laws in connection with initial coin offerings ("**ICOs**") by the two companies.

According to the SEC, the defendants raised funds from hundreds of investors by offering nonexistent digital "tokens" or "coins" supposedly backed by investments in real estate (in REcoin's case) and

diamonds (in DRC's case). The SEC further alleges that, in an attempt to evade the registration requirements of the federal securities laws, the defendants marketed the ICOs as sales in club memberships. Further, the SEC's complaint alleges that the defendants made false and misleading statements regarding the amount of capital raised, the investment selection process and the expected investment returns.

According to the SEC, the defendants eventually terminated the REcoin ICO by falsely claiming that the U.S. government required them to do so, when the SEC alleges that Mr. Zaslavskiy himself characterized a token of the nature he had promised as "impossible." The SEC announced that the U.S. District Court for the Eastern District of New York granted an emergency order freezing the defendants' assets.

In a joint statement on REcoin's and DRC's websites, the companies responded:

> "We believe this action is the result of a lack of legal clarity as to when an ICO or a digital asset is a security. This lack of regulatory clarity was implicitly recognized by the SEC in its recent Report of Investigation of the Distributed Organization (the "**DAO Report**"). While we disagree with the SEC's claims that the tokens we sold are securities, and will vigorously defend ourselves, we are cooperating with the SEC in the hope of resolving this issue."

In **the DAO Report**, the SEC concluded that whether a particular transaction constitutes the offer and sale of a security depends on "the facts and circumstances, including the economic realities" of the transaction, "regardless of the terminology used." In a **recent memo**, we examine the DAO Report, the question of when ICO tokens are securities and the broader implications for the token ecosystem.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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