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SEC HOT BUTTON ISSUES

- CYBERSECURITY
- CONFLICTS OF INTEREST
- EXPENSE ALLOCATION
- REGULATION D

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Presenters

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Cybersecurity: Background

- The SEC has made cybersecurity a major examination issue for broker-dealers and investment advisers

- In 2014, OCIE implemented a cybersecurity initiative designed to (i) assess cybersecurity preparedness in the securities industry and (ii) obtain information about the industry's recent experiences with certain types of cybersecurity threat

  April 2014 → OCIE announced a Cybersecurity Initiative[FN1]

  February 2015 → OCIE issued a Cybersecurity Examination Sweep Summary[FN2]

  April 2015 → SEC Division of Investment Management issued Cybersecurity Guidance[FN3]

  September 2015 → OCIE announced a 2015 Cybersecurity Examination Initiative[FN4]

- The OCIE examination priorities for 2014,[FN5] 2015[FN6] and 2106[FN7] include cybersecurity preparedness as an examination priority

Cybersecurity: Background

- In its 2015 Cybersecurity Examination Sweep Summary, OCIE revealed that:
  - Only 13% of investment advisers had written policies addressing how their firm would determine and/or apportion responsibility for client losses associated with cybersecurity incidents
  - Only 9% of investment advisers offered their customers guarantees to protect their clients against cyber-related losses
  - Only 32% of investment advisers require cybersecurity risk assessments of vendors with access to the firm's networks
- OCIE found these statistics disappointing and commented that this area needed improvement
- Investment advisers are urged to consider and address firm responsibility for, and reimbursement of, client losses resulting from cyber-attacks

Cybersecurity: SEC Guidance

The SEC has suggested a number of measures that advisers should consider in addressing cybersecurity risk:

- Conduct a periodic assessment of:
  - The nature, sensitivity and location of information that the firm collects, processes and/or stores, and the technology systems it uses
  - Internal and external cybersecurity threats to and vulnerabilities of the firm's information and technology systems
  - Security controls and processes currently in place
  - The impact should the information or technology systems become compromised
  - The effectiveness of the governance structure for the management of cybersecurity risk
- Create a strategy designed to prevent, detect and respond to cybersecurity threats
- Implement a cybersecurity strategy though written policies and procedures, such as a written information security plan ("***WISP***")
- Deploy cybersecurity software and tools to detect and protect against cyber-intrusions and other malicious activity
- Provide cybersecurity training and awareness to employees
- Consider cyber-insurance policies

Cybersecurity: WISP

A written information security plan ("***WISP***") should:

- Prioritize security measures for I.T. resources based on the sensitivity of information processed or stored by the resource and its business value
- Provide guidance (and conduct periodic training to employees) concerning information security risks and responsibilities
- Narrow and limit user rights (restricting user access and rights to only those network resources necessary for each person's job function)
- Establish controls to prevent unauthorized users from altering the network environment, elevating user privileges without authorization and moving laterally among network resources without proper administrative rights
- Provide for the generation and reasonable retention of log files underlying prioritized network activity to permit the security team to regularly assess the adequacy of the security measures in place, potential vulnerabilities or anomalous activity
- Provide for the regular review and removal of all non-essential software programs and services, and unnecessary usernames and logins

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Cybersecurity: WISP

- Provide procedures for identifying, disabling and disposing of end-of-life IT assets so as to avoid the exploitation of inactive but nevertheless connected I.T. assets

- Provide for collecting and storing only that client information which is deemed absolutely necessary for purposes of serving customers' trading and investment needs

- Establish a strict authentication requirement (where appropriate) for remote access to the firm network, user accounts, and/or other sensitive trading data by employees, vendors, customers or other third parties

- Create a network-wide use of data encryption (*e.g.*, encrypted storage of consumer data, encrypted storage of sensitive employee data (*e.g.*, health and social security related
- information), protocols for encrypted transmission of sensitive consumer-related data (*e.g.*, password-protected and encrypted transmissions via FTP websites))

Polling Question

- Do you conduct due diligence on third parties who maintain firm or client confidential information (e.g., cloud providers) and/or have access to it (e.g., I.T. consultants)?

Cybersecurity: Polices and Procedures

Investment advisers are strongly encouraged to:

- Designate someone in upper management (typically a chief information officer) to be responsible for oversight of cybersecurity even if IT is outsourced
- Deploy anti-virus software
- Conduct penetration testing and vulnerability scans
- Encrypt personally identifiable customer information ("***PII***") and other sensitive trading-related data (i) when/if stored in the firm's network environment and (ii) when/if transmitted to or from the firm's network environment
- Institute strong authentication procedures for remote access by employees, vendors, customers and other third parties

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Cybersecurity: Polices and Procedures

- Configure network, software and/or web application firewalls (*e.g.*, Windows Firewall) to protect PII and other sensitive data
- Establish written security alert thresholds
- Regularly monitor the activity of third-party vendors or service providers with access to firm networks
- Regularly monitor for the presence of unauthorized users, devices, connections and software on the firm network
- Use data loss or exfiltration prevention software, which essentially prevents both employees and third parties who hack into the system from exporting customer data and/or proprietary information (*e.g.*, trading data) out of the network environment
- Regularly evaluate remotely-initiated requests for transfer of customer assets to identify anomalous and potentially fraudulent requests

Cybersecurity: Enforcement

- **R.T. Jones Capital Equities Management, Inc.** (September 2015) (N8) – The SEC has brought one enforcement action against an adviser for the failure to have appropriate written policies and procedures that compromised the PII of approximately 100,000 individuals. The case was brought even though the firm self-reported and took appropriate action, and there were no customer losses. The SEC noted that the investment adviser did not have such written safeguards in place in advance of the cyber-attack, and issued a $75,000 fine.

- **2016 SEC Speaks** (February 2016) – Deputy Enforcement Director Stephanie Avakian identified three categories of cyber security enforcement issues:
  - Failures of registered entities to safeguard information (*R.T. Jones Capital Equities Management, Inc.*
  - Electronic thefts of material nonpublic information, and illicit securities trading following the thefts (*SEC v. Dubovoy*)[FN9]
  - Cyber-related disclosure failures by public companies (no actions brought to date)

- **Law Firm Breaches** (March 2016) – Various media outlets reported on March 30, 2016 that two major law firms' computer systems had been hacked. The hackers were able to retrieve large amounts of information arbitrarily, and then analyze that information to see how it could be useful.

Conflicts of Interest: Background

- The SEC has identified conflicts of interest as an enforcement priority[FN10]

- What is a conflict?

  "It is hardly a term of art. A simple Google search shows that it is used in varying ways in different contexts. I prefer to think of a conflict of interest as a scenario where a person or firm has an incentive to serve one interest at the expense of another interest or obligation. This might mean serving the interest of the firm over that of a client, or serving the interest of one client over other clients, or an employee or group of employees serving their own interests over those of the firm or its clients. This way of thinking about conflicts takes the discussion to a broad consideration of what is the right thing to do as a matter of law and ethical decision-making. It also recognizes that there are reputational risks that can be damaging or even fatal to a business organization when people or firms make decisions that may be technically within the letter of the law, but are not in keeping with the spirit of the law and hard to explain to the constituencies with which they must keep faith, such as customers, creditors, investors, or employees."*

*Carlo di Florio, "Conflicts of Interest and Risk Governance," address to the National Society of Compliance Professionals (October 22, 2012).

Polling Question

- Have you conducted an inventory of conflict issues at your firm and how you are handling them?

Conflicts of Interest: Background

Typical conflicts of interest that arise in the private investment fund context include:

- *Valuation* – Assigning higher-than-market values in order to increase fees or otherwise manipulate track records
- *Expense Allocation* – Allocating the investment adviser's expenses to one or more clients, or one client's expenses to another client
- *Trade Allocation* – Allocating limited buy or sale opportunities to clients that pay higher fees
- *Proprietary Trading Accounts* – Using research obtained for a client (at the client's expense) to trade in a personal account
- *Strategy Creep* – Trading outside of a client's strategy in order to recover losses due to bad trades within the strategy
- *Marketing Materials* – Making false or misleading statements or omissions in an effort to create a better "story" for purposes of raising capital
- *Co-Investments* – Providing a co-investment opportunity to a potential client in exchange for an increased or future commitment

Conflicts of Interest: Management

- Conflicts must be (i) identified, (ii) eliminated (where possible) or mitigated, and (iii) appropriately disclosed

- Conflicts can be mitigated by disclosure, such as via offering memoranda and Form ADV Part 2A, and having appropriate internal policies and procedures
  - Private equity funds and hedge funds typically provide that an external party – typically a limited partnership advisory committee ("***LPAC***") composed of some of the significant limited partners – must approve conflict transactions
  - Certain conflicts (*e.g.*, principal transactions) *must* be approved
  - After-the-fact disclosure in Form ADV is not effective, and disclosure outside offering memoranda may expand what is considered offering documentation and have other ramifications
  - "I believe that the best way to avoid this risk is to have a robust and detailed co-investment allocation policy which is shared with all investors. To be clear, I am not saying that an adviser must allocate its co-investments pro-rata or in any other particular manner, but I am suggesting that all investors deserve to know where they stand in the co-investment priority stack."*

*Marc Wyatt, "Private Equity: A Look Back and a Glimpse Ahead," address to Private Equity International (May 13, 2015)

Conflicts of Interest: Policies and Procedures

- The limited partnership agreement of a private investment fund should address when a referral is warranted (sometimes based on materiality, which should be defined)
- Some policies provide that the LPAC report its proposed resolution of the conflict and that the investment adviser report to investors how all conflicts were resolved
- Perform compliance testing of policies and procedures addressing conflicts of interest

Conflicts of Interest: Enforcement

- **Kohlberg Kravis Roberts & Co.** (June 2015) – KKR settled an SEC enforcement action for misallocating more than $17 million in so-called "broken deal" expenses to its flagship private equity funds in breach of its fiduciary duty. KKR agreed to pay nearly $30 million to settle the charges, including a $10 million penalty. The SEC said that "KKR's failure to adopt policies and procedures governing broken deal expense allocation contributed to its breach of fiduciary duty.... A robust compliance program helps investment advisers ensure that clients are not disadvantaged and receive full disclosure about how fund expenses are allocated."[FN11]

- OCIE in the past has identified trade allocation and co-investments as examination priories, and based on recent SEC speeches, it continues to be an enforcement priority

Expense Allocation: Background

- The SEC's Enforcement Division announced its focus on expense allocation and disclosure practices in 2013 in a SEC staff speech[FN12]

- Examples of improper conduct regarding expenses include:[FN13]
  - Shifting expenses from the investment adviser to its clients, such as by utilizing the clients' buying power to get better deals from vendors (*e.g.*, law firms and accounting firms) for the investment adviser at the expense of the clients
  - Rolling broken deal expenses into future transactions that may be ultimately paid by other clients
  - Shifting organizational expenses by causing co-mingled vehicles to foot the bill for preferred clients

- Rule 206(4)-8 of the Investment Advisers Act establishes a fiduciary-like standard for investment advisers with respect to their dealings with investors in the private funds that they advise. Advisers are also prohibited, absent adequate disclosure, from favoring one client over another

Polling Question

- Do you have a written policy regarding the allocation of expenses among the investment adviser and its clients?

Expense Allocation: Policies and Procedures

- Clear and specific disclosure should be made in offering documents and Form ADV 2A because high-level disclosure (*e.g.*, "The fund will pay a pro rata portion of certain operational, administrative, and other expenses of the General Partner that are incurred for the benefit of the Partnership") may be insufficient

- Policies and procedures should establish a process for allocation of expenses on a reasonable basis which is reviewed and approved by senior management

- The CCO should establish a compliance monitoring process to review the expense allocations

Expense Allocation: Enforcement

- **Clean Energy Capital LLC** (February 2014)[FN14] – The SEC alleged that CEC and its CEO misappropriated more than $3 million from certain funds by causing the funds to pay expenses (*e.g.*, employee related salaries and compensation, education costs for employees, and employee hiring expenses) that CEC should have paid

- **Lincolnshire Management** (September 2014)[FN15] – A settlement based on Lincolnshire's misallocation of expenses (*e.g.*, shared third party payroll and 401(k) administrator) between portfolio companies owned by different funds

- **Alpha Titans, LLC** (April 2015)[FN16] – The SEC entered into settlements with Alpha Titans and its CEO and general counsel, as well as its outside auditor, for use of fund assets (without sufficient disclosure) to pay Alpha Titan's operational expenses

Expense Allocation: Enforcement

- **Fenway Partners, LLC** (November 2015)[FN17] – The SEC charged the firm and four of its executives with failing to disclose to a private equity fund and its investors certain conflicts of interest relating to monitoring fees paid by the fund to a Fenway Partners affiliated entity and incentive compensation paid upon a portfolio company exit with respect to Fenway Partners employees. In settling the SEC's action, Fenway Partners and the four executives agreed to pay more than $10 million, including disgorgement with interest and a $1.525 million penalty

- **Cherokee Investment Partners, LLC** (November 2015)[FN18] – The SEC settled an enforcement action against private equity fund advisers for allocating (i) consulting, legal and compliance expenses to their funds related to the firm's registration as an investment adviser under the Advisers Act, (ii) expenses related to a third party compliance consultant, and (iii) expenses related to responses to the SEC exam staff and SEC enforcement staff

Regulation D: Background

- Many private equity funds and hedge funds rely on the exemption from registration under the Securities Act of 1933 set forth in Rule 506(b) of Regulation D

- Among other requirements, Regulation D includes restrictions on the resale of securities and prohibitions on general solicitation and general advertisement

- Two new rules impacting Regulation D are as follows:
  - **Rule 506(c): General Solicitation** – Permits broad solicitation and general advertisement without losing the exemption from registration if certain steps are taken
  - **Rule 506(d): Bad Actor Rule** – The Rule 506 exemptions from registration are not available if the issuer or certain persons associated with the issuer have been subject to certain disqualifying "bad acts"

Regulation D: Bad Actor Rule

- The Rule 506 exemption is not available if "covered persons" have a history of "disqualifying events"

- *Covered Persons* – The entities and individuals whose "bad act" could cause Rule 506 to be unavailable for a fund are as follows:
  - The fund, any predecessor of the fund, and any affiliated issuer of the fund
  - Any director of the fund, executive officer of the fund, or other officer of the fund participating in the offering
  - Any general partner or managing member of the fund
  - Any director, executive officer or other officer participating in the offering of any general partner or managing member of the fund
  - Any beneficial owner of 20% or more of the fund's outstanding voting equity securities, calculated on the basis of voting power
  - Any promoter connected with the fund in any capacity at the time of the offering
  - Any investment manager of the fund (including any subadviser) and any director or executive officer of the investment manager or other officer of the investment manager participating in the offering
  - Any general partner or managing member of such investment manager and any director or executive officer of such general partner or managing member or other officer of such general partner or managing member participating in the offering
  - Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities (a "***solicitor***")
  - Any director or executive officer of such solicitor or other officer of such solicitor participating in the offering
  - Any general partner or managing member of such solicitor, and any director or executive officer of such general partner or managing member or other officer of such general partner or managing member participating in the offering

Regulation D: Bad Actor Rule

Disqualifying Events – Include:

- Certain criminal convictions
- Certain court injunctions and restraining orders
- Final orders of certain state and federal regulators
- Certain SEC disciplinary orders
- Certain SEC cease-and-desist orders
- SEC stop orders and orders suspending the Regulation A exemption
- Suspension or expulsion from membership in a self-regulatory organization ("***SRO***"), such as FINRA, or from association with an SRO member
- U.S. Postal Service false representation order

Regulation D: Bad Actor Rule

- In order to establish the lack of any disqualifying events with respect to covered persons, investment advisers should:
  - Determine which entities and individuals are covered persons with respect to the fund's offering of interests
  - Obtain from each covered person a written certification that the covered person is not subject to any disqualifying events
  - For each covered person that is a third party investment adviser, subadviser or solicitor for the fund, perform a search of the SEC's Investment Adviser Public Disclosure database or the Financial Industry Regulatory Authority's BrokerCheck database, as applicable, and a basic internet search (*e.g.*, using Google) to look for any obvious indications that the investment adviser, subadviser or solicitor or its senior personnel have been subject to possible disqualifying events
  - Maintain records indicating that the investment adviser has made a reasonable factual enquiry with respect to each covered person that supports a conclusion that the covered person is not subject to any disqualifying event

- Should the investment adviser become aware that a covered person has become subject to a disqualifying event, the investment adviser must cause the fund to suspend all sales of interests in the fund until such time as (i) the person has ceased to be a covered person of the fund, or (ii) the fund has obtained from the SEC a determination that it is not necessary under the circumstances for the Rule 506 exemption to be denied to the fund (notwithstanding the continued association with the fund of the covered person)

Regulation D: Enforcement

- **SEC Alert** (March 2014) – You should not trust any individual or firm that points to a Form D filing as evidence of registration – in any capacity – with the SEC. If individuals or firms falsely claim that they are registered with the SEC, do not trade with them, do not give them any money, and do not share your personal information with them. Submit a complaint and report their misrepresentations to the SEC.[FN19]

- An inter-divisional group was created to review the new market and the practices that develop from Regulation D amendments and evaluate the range of accredited investor verification practices used by issuers and other participants in these offerings, and endeavor to identify trends in this market, including in regard to potentially fraudulent behavior; develop risk characteristics regarding the types of issuers and market participants that conduct or participate in offerings involving general solicitation and general advertising and the types of investors targeted in these offerings; the use of performance claims in the marketing of private fund interests; identify potentially fraudulent behavior and to assess compliance with the federal securities laws, including appropriate Investment Advisers Act provisions.[FN20]

- The SEC has granted numerous exemptions from the "bad actor disqualifications" as the result of SEC enforcement actions

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Notes

FN1 National Exam Program Risk Alert: OCIE Cybersecurity Initiative (April 15, 2014), *available at* https://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf

FN2 National Exam Program Risk Alert: Cybersecurity Examination Sweep Summary (February 3, 2015), *available at* https://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf

FN3 Guidance Update: Cybersecurity Guidance (April 2015), *available at* https://www.sec.gov/investment/im-guidance-2015-02.pdf

FN4 National Exam Program Risk Alert: OCIE's 2015 Cybersecurity Examination Initiative (September 15, 2015), *available at* https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf

FN5 National Exam Alert: Examination Priorities for 2014 (January 9, 2014), *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf

FN6 National Exam Program: Examination Priorities for 2015 (undated), *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf

FN7 National Exam Program: Examination Priorities for 2016 (undated), *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf

FN8 https://www.sec.gov/litigation/admin/2015/ia-4204.pdf

FN9 https://www.sec.gov/litigation/litreleases/2015/lr23319.htm

FN10 National Exam Alert: Examination Priorities for 2014 (January 9, 2014), *available at* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf

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FN11 https://www.sec.gov/news/pressrelease/2015-131.html

FN12 Bruce Karpati, "Private Equity Enforcement Concerns," address to Private Equity International Conference (January 23, 2013), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1365171492120

FN13 Bruce Karpati, "Private Equity Enforcement Concerns," address to Private Equity International Conference (January 23, 2013), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1365171492120

FN14 https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540849548

FN15 https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543006673

FN16 https://www.sec.gov/litigation/admin/2015/34-74828.pdf

FN17 https://www.sec.gov/litigation/admin/2015/ia-4253.pdf

FN18 https://www.sec.gov/litigation/admin/2015/ia-4258.pdf

FN19 https://www.sec.gov/enforce/investor-alerts-bulletins/investoralertsia_falsereg.html

FN20 Norm Champ, "Current SEC Priorities Regarding Hedge Fund Managers," address to Private Equity International Hedge Fund Management Conference (September 12, 2013), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370539802997