

2016 Regulatory and Enforcement Focus:

How legislation, enforcement actions and investor trends are impacting alternative asset managers

Wendy Beer, Head of Business Consulting, Wells Fargo Prime Services

As the new year begins, alternative asset managers should take some time to consider regulatory action items that may impact business operations in the coming year. The following paper will address the 2016 regulatory forecast and areas of enforcement, as well as common legal requests seen by large allocators.

The following are key takaways from Wells Fargo Prime Services' *On the Horizon* conference series held on January 20, 2016 featuring:

- **Robert Leonard**, Partner, Proskauer Rose LLP
- **Michael Mavrides**, Partner, Proskauer Rose LLP



The 2015 Enforcement Landscape

Mike Mavrides described 2015 enforcement cases by the U.S. Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") as following the "Broken Windows" approach. Faced with resource constraints and political pressure to bring enforcement actions to "stop the rogue actors," SEC actions are focused on setting precedent through enforcement.

In 2015 the SEC focused on fees and expenses in the context of private funds and their investment advisers. This focus has resulted in enforcement cases concentrated in three key areas:

1. The allocation of operational, administrative and compliance expenses
2. The distribution of costs incurred in unconsummated portfolio company acquisitions
3. The disclosure of accelerated monitoring fees upon the sale of, or public offering by, a portfolio company

Notable enforcement actions

Alpha Titans

The case: The Fund settled allegations that they improperly used fund assets to pay for adviser-related operating expenses.

The result: The SEC found that the fund failed to make clear and accurate disclosure that fund assets were being used to pay these expenses. The fund made full reimbursement to clients and paid a disgorgement fee and the principal general counsel were barred from the industry for 12 months.

The rationale: "Alpha Titans did not make the proper disclosures for clients to decipher that the funds were footing the bill for many of the firm's operational expenses," said Marshall S. Sprung, Co-Chief of the SEC Enforcement Division's Asset Management Unit. "Private fund managers must be fully transparent about the type and magnitude of expenses they allocate to the funds." U.S. Securities and Exchange Commission Press Release No. 2015-76, April 29, 2015.

Kohlberg Kravis Roberts & Co. ("KKR")

The case: This was the first SEC case to charge a private equity advisor with misallocating broken deal expenses.

The result: In settling the case KKR paid more than \$14 million in disgorgement, more than \$4.5 million in prejudgment interest and a \$10 million penalty. The firm previously paid \$3.26 million to clients in connection with these expenses.

The rationale: "KKR's failure to adopt policies and procedures governing broken deal expense allocation contributed to its breach of fiduciary duty," said Marshall S. Sprung, Co-Chief of the SEC Enforcement Division's Asset Management Unit. "A robust compliance program helps investment advisers ensure that clients are not disadvantaged and receive full disclosure about how fund expenses are allocated." U.S. Securities and Exchange Commission Press Release No. 2015-131, June 29, 2015.

Blackstone

The case: Three private equity fund advisers within the Blackstone Group agreed to pay nearly \$39 million to settle charges that they failed to fully inform investors about benefits that the advisers obtained from accelerated monitoring fees and discounts on legal fees.

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- Mike Marides, Proskauer Rose LLP

The result: The Blackstone Group paid \$39 million to settle the SEC case with \$29 million of the settlement due to investors.

The rationale: “Full transparency of fees and conflicts of interest is critical in the private equity industry and we will continue taking action against advisers that do not adequately disclose their fees and expenses, as Blackstone did here,” said Andrew J. Ceresney, Director of the SEC’s Division of Enforcement. U.S. Securities and Exchange Commission Press Release No. 2015-235, October 7, 2015.

Takeaways

While the above cases were not the only fee and expenses cases brought by the SEC in 2015, they show a clear trend - as the SEC continues its review of the private fund industry’s treatment and disclosure of fees and expenses, it is likely that additional investigations and actions will follow in these as well as other areas that have yet to be identified.

Specifically, it is expected that the SEC will continue to scrutinize the allocation of expenses to a fund and contest any allocations that are not expressly or specifically covered in the Fund’s governing documents, particularly where allocating the expenses to the fund is inconsistent with market practice.

Forecast of 2016 Regulatory and Enforcement Areas of Focus

1. Outsourced Chief Compliance Officer (“CCO”)

Rob Leonard summarized that the SEC’s view on outsourced CCOs as not favorable – OCIE generally views “boots on the ground” as having more of a finger on the pulse of what is actually happening with alternative asset managers (“AAM”). The following are suggested practices:

- *Communications:* Frequent, and personal interactions (rather than pre-defined checklists and electronic communications) between the outsourced CCO and AAM employees
- *Resources:* The outsourced CCO must be able to substantively perform compliance duties for each of the AAMs for which it is serving as outsourced CCO
- *Empowerment:* Annual reviews must be based on the outsourced CCO’s direct and full access to the AAM’s records and information regarding the business’ operations, as opposed to records being selectively disclosed for review. Outsourced CCOs also must have authority to implement changes to the AAM’s compliance policies and procedures.
- *Meaningful Risk Assessments:* Outsourced CCOs must be able to identify risks and design compliance policies and procedures to address those risks. Standardized checklists that are generic and not specifically tailored to the AAM’s business are not sufficient

2. Continued focus on allocation of expenses

It is expected that regulators continue to scrutinize the allocation of expenses to the clients by AAMs. Reviews will be focused on the appropriateness of specific fees/expenses as well as how they are allocated amongst clients.

3. Continued focus on cybersecurity

Regulators will continue to test how AAMs are implementing controls (taking into account fund structure and AUM). Every AAM needs to have a comprehensive cybersecurity plan in place. Firms should expect the adequacy of their policies to be tested by examiners. For more detail and cybersecurity practices, please refer to our paper [“Cybersecurity Preparedness, Combating Today’s Threats.”](#)

4. Pay to play

Given that it is an election year, Rob and Mike reminded managers to think about the Pay to Play rules when making a donation or hosting an event. The rule applies to all levels of state and local government – especially important if you host a state official and then your fund receives investments from that state’s pension plan – this could be a rule violation.

5. Insider trading

It was emphasized that the SEC will continue its scrutiny of AAM’s use of “experts” and consultants. It’s very important to have policies and procedures around the receipt and handling of material non-public information, especially when it comes to working with consultants from expert networks. Recently, the U.S. Supreme Court has agreed to hear the U.S. vs. Salman case which could potentially resolve a possible split between the Ninth Circuit and Second Circuit courts on the type of “personal benefit” that constitutes a violation of federal securities laws.

6. Whistleblowing

There is growing scrutiny around nondisclosure provisions in employments letters – anything that might inhibit an employee from speaking. If the employee feels a chill on communications, there will be scrutiny.

7. Conflicts

Potential conflicts should be vetted and, where appropriate, disclosed. For example, conflicts due to the existence of certain relationships and preferential treatment, such as issues involving fund investors affiliated with BDs, other private funds or other entities with which a fund or adviser may have dealings. Also included should be actions around side letters, soft dollars and allocation of investment opportunities and expenses.

The January 11, 2016 SEC staff announcement of OCIE Examination Priorities sets a robust agenda of areas to be examined, which include both continuations of past themes as well as new initiatives. While the announcement itself covers all entities regulated by the SEC (excluding the national securities exchanges), advisers to private funds would be well-served to devote time and resources to assessing and assuring their preparedness in the specific areas articulated above ,”

- Robert Leonard and Michael Mavrides, Proskauer Rose LLP

About On the Horizon conference series

As markets move and regulations change, alternative asset managers need to remain at the forefront of issues. Our Business Consulting group hosts “On the Horizon”, a regular morning conference series, where key industry experts discuss vanguard topics specifically effecting alternative asset managers.

About Wells Fargo Prime Services

Part of the Institutional Investor Services group, Wells Fargo Prime Services offers comprehensive prime brokerage services and solutions for alternative asset managers. Through our multi-asset class platform, we help managers meet their operational and financial goals with:

- Integrated financing solutions
- Technology and operational solutions
- Capital introductions
- Business consulting services
- Risk management solutions

About the Business Consulting group

The Business Consulting group delivers subject matter expertise for alternative asset managers including: business development (from launch to franchise management), best practices, peer analysis and benchmarking, and thought leadership.

We help fund managers focus on their day-to-day investment objectives and improve the efficiency of their operations. By leveraging our knowledge of industry service providers we facilitate key introductions and discussions to achieve the right operational fit for our customers’ business. We offer subject matter expertise across the full spectrum of hedge fund operations including formation and structure, strategic growth, trading workflows, and technology platforms.

To learn more about our thought leadership initiatives:

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