JACKO LAW GROUP, PC

Legal Risk Management Tip
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BACK TO BASICS – PRIVATE EQUITY COMPLIANCE - BEYOND FEE AND EXPENSE PRACTICES

Introduction

In his May 2014 speech titled "Spreading Sunshine in Private Equity," Andrew Bowden, the Director of the Office of Compliance, Inspections and Examination ("OCIE") of the U.S. Securities and Exchange Commission ("SEC") publicly announced that the private equity sector had become a focus for OCIE.[1] Over the next two years, the financial services industry has seen a continued and increasing focus by OCIE, and by the SEC's Division of Enforcement, on the private equity space. Recent comments by Jane Jarcho, the new Deputy Director of OCIE, indicate that private equity advisers and their funds will remain as a high priority for the SEC in 2017.[2]

Over the past two years, the private equity fund issues making the most SEC enforcement headlines relate primarily to fund fee and expense practices and the proper disclosure of those practices.[3] However, when examining private equity advisers and referring matters to the Enforcement Division, the SEC will look at the adviser's entire compliance program to review not only the high priority focus areas listed in Examination Priorities,[4] but also compliance with an adviser's other policies and procedures, in addition to the high priority areas. With the end of 2016 approaching, this Legal Tip is intended to highlight select areas, *other than* fee and expense practices, where private funds and their advisers may want to devote additional time and attention as they begin the annual review process.

Private Fund Sales Practices

The topic of how private equity funds are sold reaches a surprising number of areas of a fund adviser's compliance program.

Starting with the basics, most advisers have a Marketing Policy (or equivalent) that requires pre-clearance of fund slide decks and marketing materials by Compliance before distribution to investors, prospects and other third parties. Ensuring the necessary compliance reviews are performed is a mandatory first step to ensure a healthy (*i.e.*, compliant) sales function.

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[1] Andrew J. Bowden, Director, OCIE, "Spreading Sunshine in Private Equity," May 6, 2014, available at https://www.sec.gov/news/speech/2014--spch05062014ab.html.
[2] Jane Jarcho, Deputy Director, OCIE, Remarks at IAA Compliance Workshop, Sept. 22, 2016 (as reported in IAA Newsletter, Oct. 2016).
[3] *See, e.g., In the Matter of Kohlberg Kravis Roberts & Co., L.P.* (June 29, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4131.pdf; *In the Matter of W.L. Ross & Co. LLC* (Aug. 24, 2016), available at https://www.sec.gov/litigation/admin/2016/ia-4494.pdf.
[4] See, e.g., SEC 2016 Examination Priorities, available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

Many of us remember a speech a few years ago by David Blass, then Chief Counsel of the SEC's Division of Trading and Markets, in which he summarized a long-time SEC position that private fund advisers may engage in activities that require broker-dealer registration when marketing interests in their private funds.[5] Mr. Blass stated the view that transaction-based compensation was a "hallmark of being a broker," and went on to note that a marketing department of a private fund adviser in which a dedicated sales force who primarily solicits or seeks to retain fund investors is a strong indicator of a business "effecting transactions" in the private fund, regardless of how those employees are compensated.[6] If you have not recently reviewed the activities of the individuals who actively market your private fund(s), now is the right time to do so.

Additionally, other notable traditional compliance areas that relate to private fund sales practices include:

- Solicitation Policy – do you have a policy requiring certain steps be undertaken before an investor prospect may be approached, and offering materials delivered to that prospect?[7]
- Recordkeeping Policy – are you keeping required materials delivered to prospects and investors in accordance with your compliance policy requirements?
- Gift & Entertainment Policy – are your business development efforts compliant with the applicable policy limitations?

Rule 506(d) "Bad Actor" Due Diligence

By now, it is well known that private offerings are subject to Rule 506(d)'s "Bad Actor" requirements such that an issuer of securities of a private fund will not be permitted to rely on the Rule 506 exemption from registration if the issuer or any other "covered person" has experienced a "disqualifying event" as identified in Rule 506(d).[8] Generally, "covered persons" include, without limitation, the issuer, the General Partner or Managing Member, the issuer's directors and officers, investment managers, significant beneficial owners and third party promoters. "Disqualifying events" include, among others, felonies or misdemeanor convictions related to securities within the past 10 years; regulatory, disciplinary and final orders within the past 10 years; and suspensions and bans.

Against that backdrop, some questions to ask during this year's annual compliance review include:

- Are you collecting "Bad Actor" certifications from the covered persons related to your private fund offering?

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[5] David W. Blass, Chief Counsel, Division of Trading and Markets, "A Few Observations About the Private Fund Space," Apr. 5, 2013, available at http://www.sec.gov/News/Speech/Detail/Speech/1365171515178.
[6] *Id.*
[7] *See, e.g.*, Citizen VC, Inc. No Action Letter (Aug. 6, 2015), available at https://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm.
[8] Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to adopt rules disqualifying securities offerings involving certain felons and other 'bad actors' from reliance on Rule 506 of Regulation D of the Securities Act of 1933. Rule 506(d) was adopted by the SEC and became effective on Sep. 23, 2013.

- Are the certifications current and have they been obtained from any new covered persons?
- Are your protocols and efforts consistent with your written policies and procedures?

Pay to Play Considerations

Given the November election is right around the corner, you have probably had to address Investment Advisers Act Rule 206(4)-5 (the "Pay to Play Rule") and pay to play issues over the past several months as personnel have sought to donate to political campaigns and candidates. At a high level, the Pay to Play Rule prohibits an adviser from (i) providing advisory services for compensation to a government entity,[9] elected official[10] or candidate for two years after the adviser, or any covered associate[11] of the adviser, makes a contribution[12] to such an entity, (ii) providing direct or indirect payments to any third party that solicits government entities for advisory business unless this third party is also a regulated person, and (iii) soliciting from others, or coordinating contributions from others for an elected official who is in a position to influence the selection of the adviser.[13] The Pay to Play Rule applies with equal force to an adviser to a pooled investment vehicle in which a government entity invests or is solicited to invest.[14]

Given that public pension advisers were listed as a 2016 SEC Examination Priority,[15] which will likely continue into the SEC's 2017 Examination Priorities,[16] those fund advisers who work with

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[9] *Government entity* means any State or political subdivision of a State, including: (i) any agency, authority, or instrumentality of the State or political subdivision; (ii) a pool of assets sponsored or established by the State or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a "defined benefit plan" as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a State general fund; (iii) a plan or program of a government entity; and (iv) officers, agents, or employees of the State or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity.

[10] *Official* means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.

[11] *Covered associate* of an investment adviser means: (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser.

[12] *Contribution* means any gift, subscription, loan, advance, or deposit of money or anything of value made for: (i) the purpose of influencing any election for Federal, State or local office; (ii) payment of debt incurred in connection with any such election; or (iii) transition or inaugural expenses of the successful candidate for State or local office.

[13] For additional details about Pay to Play Rule requirements, see SEC Adopting Release No. IA-3043 (Sep. 13, 2010), available at https://www.sec.gov/rules/final/2010/ia-3043.pdf.

[14] Per Rule 206(4)-5(f)(3), a "covered investment pool" means any investment company registered under the Investment Company Act of 1940, as amended (the "Act"), that is an investment option of a plan or program of a government entity, or any company that would be an investment company under section 3(a) of the Investment Company Act of 1940 but for the exclusion provided from that definition by either Section 3(c)(1), 3(c)(7) or 3(C)(11) of the Act.

[15] *See* SEC 2016 Examination Priorities, available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

[16] *See* Jarcho Remarks at IAA Compliance Workshop, Sep. 22, 2016 (as reported in IAA Newsletter, Oct. 2016).

or seek business from government clients should pay close attention to Pay to Play issues and compliance with Pay to Play policies and procedures.

Conclusion

The SEC's interest and focus on private equity continues to increase and is a consistent topic of speeches and announcements by OCIE and the Division of Enforcement. Private equity fund advisers should consider taking the following steps in connection with their regulatory compliance efforts:

- Perform a thorough review of current compliance policies and procedures to ensure they accurately reflect current operations.
- Consider whether marketing practices are compliant with all applicable policies, and that compensation for sales or marketing personnel is consistent with applicable regulatory guidance.
- Review and enhance, as necessary, methods used to screen and collect information about firm and employee political contributions, especially if your firm has or intends to pursue government clients.
- Confirm that "Bad Actor" certifications are collected and current from all covered persons in accordance with applicable policies and procedures.
- Ensure that the CCO and the adviser's compliance program has sufficient resources and is deeply integrated into the firm's business operations.
- *Risk Management Tip*: Retain counsel to evaluate regulatory compliance practices, perform internal control and conflicts of interest reviews, and proactively and timely make enhancements to strengthen compliance program efforts.
- Frequently review investor disclosure documents to help ensure that conflicts are clearly and adequately disclosed.

For more information on this topic, please contact us at (619) 298-2880 or at info@jackolg.com.

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