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ACA Insight

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"If the regulatory agencies are aware of these state-specific restrictions, investment advisers better be as well."

Inside Insights

7 Donohue Returning to SEC

State Pension Fund Investments at Heart of SEC Charges Against Adviser

Violate state law and you may find your firm facing SEC fraud charges.

That's one message to take from the SEC's May 21 administrative order against **Gray Financial Group**, an Atlanta-based adviser that specializes in public and private pension funds nationwide. The firm allegedly made improper recommendations to several public pension fund clients. Specifically, the adviser recommended that the pension funds invest in an alternative investment fund of funds managed by Gray Financial. Between November 2012 and the end of December 2014, approximately $1.7 million in fees were collected by the advisory firm in connection with these investments, the SEC said.

continued on page 2

Private Equity: What the SEC Plans to Target

Expect more private equity enforcement in the coming months.

The SEC spent much of the past two years boning up on private funds and the advisers who manage them. It conducted presence exams to increase its own knowledge, hired individuals with private fund experience to provide in-house expertise, and formed a Private Funds Unit in its exam division dedicated to looking at private funds. And it tested the waters with its first enforcement cases.

Now, armed with increased private fund knowledge and internal resources, some enforcement experience, and the citations given to advisory firms from examina-

continued on page 4

Confidentiality Agreements Are Still Okay, Except …

The SEC caused a bit of a ruckus among attorneys representing advisory firms and other companies with a recent ruling that targeted confidentiality agreements. It turns out that the attorneys' concerns may have been a bit over the top – but perhaps not totally so.

That would seem to be the takeaway from comments made by SEC chair **Mary Jo White** on April 30 in Chicago in the wake of the agency's April 1 enforcement action against **KBR**, for allegedly using confidentiality agreements to stifle would-be whistleblowers from reporting (*ACA Insight*, 4/13/15).

continued on page 6

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State Pension Fund Investments

continued from page 1

Georgia law allows public pension funds to invest in alternative investments, but only under certain conditions, which the SEC, in an administrative order against Gray Financial and two of its top executives, claims were not met.

"Gray Financial Group breached a fiduciary duty to public pension fund clients by recommending investments it knew did not comply with legal requirements," said SEC Division of Enforcement director **Andrew Ceresney**. "To make matters worse, the firm profited handsomely from this alleged failure."

"The claims and arguments in the SEC's filing are without merit," said an attorney representing Gray Financial and its two executives. "The SEC is once again bringing its charges in an unconstitutional and home-cooked administrative proceeding rather than trying a case before an impartial U.S. district court and a jury of one's peers. ... Gray Financial will vigorously defend itself and continue to fight the SEC in federal court as well as in these administrative proceedings."

Gray's pre-emptive strike

In an attempt to head off the SEC's case, Gray Financial Group and its two executives in February filed a complaint against the agency for what was then the SEC's plan to bring its charges in an administrative proceeding, which Gray Financial said would rob the three parties of their constitutional protections.

"Without injunctive relief from this Court, plaintiffs will be required to submit to an unconstitutional proceeding," the firm's complaint before the U.S. District Court for the Northern District of Georgia states. "This violation of a constitutional right, standing alone, constitutes an irreparable injury. The lack of traditional procedural safeguards in SEC administrative proceedings further exacerbates that harm."

The agency's increased use of administrative proceedings to try cases against advisers and others has come under criticism from a variety of parties, including an SEC commissioner, a federal judge and several defense attorneys (*ACA Insight*, 5/25/15). It would appear that Gray Financial is employing many of the same arguments against such proceedings in its case against the SEC.

States and enforcement

"The SEC appears to be effectively enforcing state laws by knowing the state-specific investment restrictions in place for public pensions and appears ready to aggressively pursue advisers that fail to adhere to those restrictions," said **ACA Compliance Group** principal consultant **Ted McGrath**. "A key takeaway from these charges is the understanding that if the regulatory agencies are aware of these state-specific restrictions, investment advisers better be as well."

McGrath also noted that the charges are the result of the efforts of the SEC's Atlanta Regional Office working with the Enforcement Division's nationwide Municipal Securities and Public Pensions Unit. "Advisers should be aware that there is a task force out there specifically looking for this type of thing," he said.

"The novel twist in this case appears to turn in part on an interpretation of state law," said **Zaccaro Morgan** partner **Nicolas Morgan**. "As is typical, the SEC's case draws a contrast between what the adviser told investors versus what the SEC alleges is actually true. However, one of the adviser's representations dealt with whether an investment complied with Georgia law."

"The adviser reportedly (according to Gray Financial's complaint against the agency) received legal advice on the issue, and the SEC's case will turn in part on whether the investments do or do not comply with state law," he said. "While it's not clear precisely what legal advice the adviser received, the SEC obviously thought that it was insufficient to preclude fraud allegations. As a rule, anytime an adviser relies on legal advice, it is imperative to be able to demonstrate that the adviser fully disclosed all material facts to its attorney before seeking advice, and actually relied on counsel's advice in the good faith belief that the conduct was legal. In the absence of either factor, the SEC will discount the adviser's reliance on advice of counsel."

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Georgia allowances and restrictions

The state of Georgia has, since 2012, allowed eligible large public pension funds to invest in alternative investments – but those investments are subject to restrictions. According to the SEC, these criteria include:

- No single Georgia-based public pension fund's investment in an alternative instrument may exceed 20 percent of the aggregate amount to be invested in the applicable private pool;
- Each alternative investment must be either concurrently made or committed to be made by at least four other investors not affiliated with the issuer; and
- Any alternative investment pools and issuers must have at least $100 million in assets, including committed capital, at the time the investment is either made or committed to be made.

The pension funds and the investments

Among the pension funds that Gray Financial advised were the **City of Atlanta Firefighters' Pension Fund**, the **City of Atlanta General Employees' Pension Fund**, the **City of Atlanta Police Officers' Pension Fund**, and the **MARTA/ATU Local 732 Employees Retirement Plan**.

In 2012, Gray Financial owner and president **Laurence Gray** and chief operating officer **Robert Hubbard IV** created the alternative-based fund of funds that it would market to public pension funds. According to the SEC's administrative order, marketing of the fund fell to Gray, while Hubbard was largely responsible for arranging the drafting of the offering and subscription documents, providing investors' names to Gray, and tracking the date and amount of the investments.

Here's how the SEC delineates the investments of the public pension funds that invested in Gray Financial's alternative funds of funds:

- **Atlanta Firefighters Pension**. Invested $15 million on October 20, 2012, thereby comprising 19.2 percent of total fund assets.
- **Atlanta Police Pension**. Invested $21 million on October 22, 2012, comprising 26.9 percent of total fund assets.
- **Atlanta General Pension**. Invested $28 million as of November 7, 2012, making up 35.9 percent of total fund assets.
- **MARTA/ATU Retirement**. Invested $13 million as of November 30, 2012, comprising 16.7 percent of total fund assets.

These fund investments, combined with $1 million from a Gray Financial affiliate that serves as the fund's general partner, totaled $78 million, the SEC said, but did not meet any of the three restrictions the agency listed in its action. Specifically, the agency charged that:

- The fund never met the $100 million threshold required for investment.
- Two of the pension funds – Atlanta Police Pension and Atlanta General Pension – made investments that exceeded the 20 percent statutory ceiling.
- Each of the investments from the four public pension funds fell outside the statutory requirement that four non-issuer affiliated investors exist prior to the investment by a Georgia public pension fund.

Misrepresentations

Gray Financial and Gray made "two specific material misrepresentations" to the Atlanta General Pension relating to investments in the alternative fund of funds, the SEC said.

The first alleged misrepresentation was that Gray told the board that Atlanta General Pension's proposed investment in the Gray Financial fund was legal, the agency said. When asked by a pension fund trustee prior to voting if the investment was consistent with the law, Gray responded that it 'absolutely' was and that "'the only reason you can do this now is because of the change in the law,'" the SEC said. "Gray knew, was reckless in knowing, or should have known his claim was false, as the three relevant limitations of the [applicable law] were not met at that time," the agency said.

The second alleged misrepresentation was that Gray "falsely stated that certain other public pension clients had already invested in [the fund]." In fact, the SEC said, they had not yet done so.

Violations

Gray Financial and Gray were charged with willfully violating Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and its Rule 10b-5, which prohibit fraud in the offer and sale of securities. In addition, the agency charged that Hubbard willfully violated Sections 17(a)(1) and (3) of the Securities Act and Section 10(b) of the Exchange Act, as well as its Rule 10b-5(a) and (c).

But that's not all. Charges of violating the Advisers Act were also leveled. Gray Financial and Gray were accused of willfully violating Sections 206(1), 206(2) and 206(4) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, as well as Rule 206(4)-8. Hubbard also allegedly "willfully aided, abetted, and caused Gray Financial and Gray's violations of Section 206(1), 206(2), and 206(4)," as well as Rule 206(4)-8(a)(2).

Private Equity

continued from page 1

tions conducted over the past two years, the agency is likely to bring more enforcement actions in the months ahead. **Marc Wyatt**, the new acting director of the SEC's Office of Compliance Inspections and Examinations, addressed private equity in particular during a May 13 speech at **Private Equity International** in New York City.

Examinations and enforcement

Examination results are likely to provide a fertile field for enforcement. "It's important to understand that we work closely with our colleagues in the [Division of] Enforcement and that there is a natural lag between examination and enforcement activity," Wyatt said. He added that there can be a time lag of "two years or longer between the time an examination uncovers problematic conduct and the public announcement of an enforcement action or settlement."

Well, guess what? Since OCIE began its presence exams of private funds in October 2012, a fact Wyatt mentioned in the speech, that time lag should be near an end and the citations may begin bearing fruit. "It is reasonable to assume that the next year may bring additional private equity actions by the SEC's Division of Enforcement," he said.

Part of the reason behind Wyatt's warning is "deterrence," said **Sidley Austin** partner **Timothy Clark**. What the SEC is saying to advisers is that "it's not just examination deficiency letters. There are enforcement actions."

Beyond the message to advisers, the SEC wants to prepare the marketplace for upcoming enforcement, he said. "They are putting investors on notice that some managers may turn up in an enforcement action." By linking the examination results to possible future enforcement, Wyatt is "trying to put a narrative behind what's coming up. He's giving you a road map as to how examinations and enforcement are working closely together."

"What the SEC is saying is, 'Don't take a deep breath and think it's over now that the presence exams are completed,'" said **Day Pitney** counsel **Eliza Sporn Fromberg**. "I would expect more enforcement activity."

Wyatt "is definitely setting things up for more action this year and next year, given the results of the presence exams," said **Mayer Brown** attorney **Adam Kanter**. At the same time, he noted, given that private equity has also been mentioned in recent speeches by other SEC officials, Wyatt "is making the point that private equity is in the agency's cross-hairs."

The SEC push to examine and, when necessary, take enforcement action against advisers to private funds is because private fund advisers with more than $100 million in assets under management were, beginning in 2012, required by Dodd-Frank to register with the SEC. Those advisers that, until that point, had little experience with SEC registration, had to adapt to the agency's rules and regulations, as well as its examinations.

Private equity investigation areas

Transparency and full disclosure appear to be the agency's primary concerns. The SEC wants advisers managing private equity funds to disclose to potential investors what the funds are doing. "Advisers to private

equity funds should go back to their limited partnership agreements and see if what they told investors is in line with what they are actually doing," said Fromberg. If not, she said, the SEC has suggested that advisers should consider going back to their limited partners and getting their consent to reflect current activities, although Fromberg noted that many advisers and funds will find that difficult to do in practice.

Wyatt expects the SEC to focus on areas it has already somewhat addressed, but for which "there is still room for improvement." Other areas are new. Among the areas he specifically mentioned in his speech were:

- **Expenses and fees.** Fee and expense allocations are "by far" the most common deficiencies that examiners have observed in private equity, Wyatt said. "Many managers still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty." Among the practices that have been most cited during examinations so far is shifting expenses from parallel funds created for "insiders, friends, family and preferred investors" to the main funds. These can include operational expenses, broken deal expenses and formation expenses. "This practice can be difficult for investors to detect but easy for our examiners to test," he said.
- **Co-investment allocation.** OCIE has found several instances where investors in one fund were not aware that another investor negotiated priority co-investment rights. "Disclosing this information is important because co-investment opportunities have a very real and tangible economic value, but also can be a source of various conflicts of interest," Wyatt said. "Allocating co-investment opportunities in a manner that is contrary to what you have promised your investors can be a material conflict and can result in violations of federal securities laws and regulations." He added that some advisers, in response to OCIE's concerns in this area, are now disclosing less, not more, information about co-allocation "under the theory that if an adviser does not promise their investors anything, that adviser cannot be held to account." But the danger in that approach is that promises, either orally or through email, are often made anyway. "The best way to avoid this risk is to have a robust and detailed co-investment allocation policy which is shared with all investors," he said.
- **Real estate advisers.** A problem here observed by examiners was that while investors have allowed fund managers to charge additional fees for vertically integrated services such as property management or construction management, it was with the understanding that these fees would be at or below a market rate. "We rarely saw that the vertically integrated manager was able to substantiate claims that such fees are 'at market or lower,'" Wyatt said. "During some of our exams, we have seen that the manager collects no data to justify their fees at all." In other situations, the data is either collected informally from calls to industry participants and not documented, or is presented to investors in a misleading way. Private equity real estate managers who promise rates at or below market level should "review their benchmarking practices to ensure they can support their claims," he said.
- **Conflicts of interest.** Wyatt referenced a speech by Division of Enforcement Asset Management Unit co-chief **Julie Riewe**, in which she said she expected the Division to recommend more prosecutions involving undisclosed and misallocated fees and expenses, as well as conflicts of interest. In that context, he said that "it is reasonable to assume that the next year may bring additional private equity actions" by the Division that would bring a "heightened awareness of reputational and headline risk by the investor community," meaning that advisers might suffer the effects of enforcement action on their credibility. "No investor wants to see their manager portrayed negatively in the media," he said.
- **Sales to retail investors.** As private equity managers develop vehicles to sell funds to retail and mass affluent investors, "full transparency is essential," Wyatt said. "It will be particularly important that retail investors understand the fees they are paying,

the conflicts that the advisers might face, and other risks inherent in the private equity model." Only with "complete and timely disclosure" can advisers meet their fiduciary duty to put their clients' and investors' interests first, he said.

The Private Funds Unit

OCIE's Private Funds Unit, which is dedicated to examining advisers to private funds, is composed of "experienced examiners who have now developed the pattern recognition" necessary so that OCIE can promote compliance, monitor risk, detect fraud, and inform policy with private funds. It is based in four of the agency's six regional offices where there is a high concentration of private fund registrants.

"The PFU's mission is to apply industry and product knowledge to conduct focused, risk-based examinations using OCIE's limited resources," Wyatt said. It targets and selects exam candidates, scopes risk areas, executes examinations and analyzes data gleaned from those examinations. While the PFU is small, "it has an outsized impact on the National Examination Program," he said.

Private equity statistics

Wyatt shared the following figures:

- The private equity industry grew by 25 percent from the end of 2011 through the second quarter of 2014, as measured by capital under management.
- Capital raised by private equity firms increased by more than 40 percent, from $354 billion in the first quarter of 2012 to $502 billion in the third quarter of 2014.
- Deal volume, by number of deals, increased by approximately 7.5 percent from the end of 2011 to the end of 2014. Deal value increased by 36 percent during that same period.
- The size of funds marketed decreased by approximately 14 percent, from $410 million in January 2012 to $355 million in September 2014. "This suggests that smaller managers are forming, contrary to industry concerns that the cost of SEC registration and regulation could stifle the formation of smaller managers," Wyatt said.
- The average size of the actual funds raised, however, increased by about 57 percent, from $316 million in the 12 months ending in March 2012 to $497 million in the 12 months ending in the second quarter of 2014. Wyatt attributed this to "the natural maturing and consolidation of the industry and the preference of some investors, especially large non-U.S. investors, for the brand and the services that larger managers can provide."

Confidentiality Agreements

continued from page 1

Under Securities Exchange Act Rule 21F-17, as amended by Dodd-Frank, individuals and entities may not take steps to prevent potential whistleblowers from contacting the SEC – including through confidentiality agreements. "The Enforcement Division has been focused on companies that use agreements or other mechanisms to improperly stifle whistleblowers from coming forward," White said in her speech.

But some may be reading too much into the enforcement action, she suggested. Concerns that the SEC has asserted "an overly broad interpretation of the rule and engaged in rulemaking by enforcement, which, in turn, has created uncertainty as to the enforceability of all confidentiality agreements" are "unwarranted," she said. "Enforcing a rule for the first time does not mean that we are engaged in rulemaking by enforcement."

"Companies conducting internal investigations can still give the standard Upjohn warnings that explain the scope of the attorney-client privilege in that setting," she said, referring to the 1981 case, *Upjohn Co. v. United States*. "Companies may continue to protect their trade secrets or other confidential information through the use of properly drawn confidentiality and severance agreements."

The key, she said, is that a company "needs to speak clearly in and about confidentiality provisions, so that employees, most of whom are not lawyers, understand that it is always permissible to report possible securities laws violations to the Commission."

Okay, but …

"I think the terrain is still pretty confused, but it's welcome that White acknowledges that the industry is looking for more guidance after the recent enforcement action," said **Shearman Sterling** partner **Nathan Greene**. "It's also welcome that she confirms that not every kind of confidentiality agreement has to be revisited."

"White's speech provides some clarification of the SEC's views on the use of confidentiality agreements after the KBR case," said **Mayer Brown** partner **Matthew Rossi**. "It's important for investment advisers to understand that although they may legitimately use confidentiality agreements appropriately tailored to protect privilege and other categories of sensitive material such as trade secrets, they must avoid language that the Commission may view as a blanket prohibition on the disclosure of all information. The Commission is likely to view such provisions as having the potential to deter whistleblowers unless the agreements also contain a specific statement carving out communications with regulatory agencies."

White also used her speaking opportunity to note that the SEC has become aware that some companies may be attempting to require that employees sign agreements mandating that the employees not accept a whistleblower award, or that employees, as a pre-condition to obtaining a severance payment, represent that they have not made a prior report of misconduct to the SEC. "You can imagine our Enforcement Division's view of those and similar provisions under our rules," she said.

Donohue Returning to SEC

The SEC announced May 28 that **Andrew Donohue** will return to the Commission as its chief of staff. He previously served as director of the Division of Investment Management for more than four years.

Donohue, who headed the Investment Management Division from May 2005 to November 2010, will replace **Lona Nallengara**, who the SEC on May 19 said plans to leave the SEC at the end of this month. Nallengara also previously headed an agency division before taking on the chief of staff role, in his case as director of the Division of Corporate Finance.

As the new chief of staff, Donohue will be a senior adviser to chair **Mary Jo White** on all policy, management and regulatory issues, the SEC said in

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announcing his appointment. Since leaving the agency, Donohue served in a variety of roles in the private sector, most recently as a managing director, associate general counsel, and investment company general counsel at **Goldman Sachs**, where he oversaw legal matters related to registered investment companies, the SEC said. Before that, he was a partner at **Morgan Lewis**.

During Donohue's time as director of the Investment Management Division, he was instrumental in developing regulations governing the asset management industry, and was responsible for policy and oversight affecting registered investment advisers and investment companies.

Nallengara was named chief of staff by White in May 2013. He was the lead adviser to her on all issues involving the SEC, the agency said, including policy development, rulemaking, strategy, and agency management. He also served as the Commission's liaison to the **Financial Stability Oversight Counsel** and was the primary SEC liaison to other financial regulators.

During Nallengara's time as chief of staff, the agency completed rulemaking addressing money market funds, asset-backed securities markets, credit rating agency operations, security-based swaps, municipal advisers and proprietary trading activity, and lifting the ban on general solicitation.

Prior to joining the SEC, Nallengara was a partner at **Shearman & Sterling** where he advised public companies and financial institutions on a wide range of capital raising activities, corporate governance, public reporting, and mergers and acquisitions.

Donohue has a law degree from the **New York University School of Law** and a bachelor's degree in economics from **Hofstra University**.

Nallengara has a law degree from **Osgoode Hall Law School** in Toronto, and an undergraduate degree in political science from the **University of Western Ontario**. ☙

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