

# Memorandum

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## SEC Announces Enforcement Action Regarding Failure to Disclose Conflict of Interest Created by Outside Business Activity

April 23, 2015

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On April 20, the SEC announced that it had reached a settlement with a prominent investment manager (the “Firm”) regarding alleged breaches of the Firm’s fiduciary duties under the U.S. Investment Company Act of 1940, as amended (the “1940 Act”), and the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”), as applicable (the “Order”). The breaches alleged by the SEC stem from a failure by the Firm to (1) disclose a conflict of interest involving the outside business activity of one of the Firm’s portfolio managers, (2) adopt and implement written compliance policies and procedures concerning the outside business activities of the Firm’s employees, how they should be assessed and monitored for conflict purposes and when they should be disclosed; and (3) report violations of the Firm’s private investment policy to the registered funds’ boards of directors as a “material compliance matter” pursuant to Rule 38a-1 under the 1940 Act. This alert focuses on the topic of assessing, mitigating and monitoring conflicts of interest associated with outside business activities for registered investment advisers, including advisers to both registered funds and unregistered/private funds more generally (and does not evaluate or comment specifically on the conduct that was the subject of the settlement with the Firm, which the Firm neither admitted nor denied).

Generally, in order to comply with its fiduciary duties under the Advisers Act and the 1940 Act, as applicable, a fund sponsor adopts compliance policies, often as part of its code of ethics, that prohibit employees from engaging in outside business activities without the prior written approval of the fund sponsor’s chief compliance officer. As part of its procedures under these policies, the fund sponsor typically requires a new employee to disclose to the CCO any outside business activities in which the employee would like to continue to engage upon hiring and obtains annual attestations from its employees that they are not engaging in any outside business activities other than those that have been disclosed to, and approved by, the CCO. Most

firms also have a policy, and/or receive attestations, that employees will obtain the CCO's prior approval before engaging in any future outside business activities. To the extent an employee is engaging in approved outside business activities, a fund sponsor generally requires the employee to inform the CCO of any changes in, or material conflicts of interest relating to, the approved outside business activities of which the employee becomes aware in the future.

The circumstances surrounding the SEC's findings in the Order are a reminder that fund sponsors should also consider implementing policies and procedures that address how they will assess the outside business activities of their employees for conflicts purposes, including who is responsible for deciding whether an outside business activity should be permitted, the types of activities that will or will not be permitted and how permitted activities will be monitored. Fund sponsors should be able to demonstrate the connection between conflicts and compliance approvals and monitoring. When an employee requests approval to engage in an outside business activity, we recommend that a fund sponsor's CCO:

1. *Analyze and Resolve Conflicts of Interest Relating to the Outside Business Activity.* First, each outside business activity must be analyzed to determine whether it would create any actual or potential material conflicts of interest with the fund sponsor's clients. In determining whether a conflict of interest may arise, it is advisable to consider relationships that the outside business activity has not just with the fund sponsor's portfolio companies, but also with those portfolio companies' counterparties. Then, each conflict of interest should be analyzed to determine whether it can be appropriately mitigated through the adoption of tailored policies and procedures and/or by disclosure to the fund's board of directors, limited partner advisory committee (to the extent applicable) or investors. If not, the best course of action may be to prohibit the employee from engaging in the activity. With respect to disclosure, in the Order, the SEC expressed its view that "[i]t is the client, not the investment adviser, who is entitled to determine whether a conflict of interest might cause a portfolio manager – consciously or unconsciously – to render advice that is not disinterested" - so even if a conflict of interest can be mitigated through controls such as tailored policies, disclosure may nonetheless be warranted.
2. *Document Analyses and Resolutions of Conflicts of Interest Relating to Outside Business Activities.* The analyses and the manner in which conflicts of interest relating to outside business activities are resolved should be documented.
3. *Proactively Monitor Changes in Approved Outside Business Activities.* Although policies relating to employees engaging in permitted outside business activities generally require employees to inform the CCO of any changes in, or material conflicts of interest relating to, such activities, CCOs should consider taking periodic proactive steps to stay informed. Some methods to proactively monitor changes include (i) periodically obtaining a certification from the employee that relates to the

specific circumstances of the outside business activities, (ii) interviewing the employee about the outside business activities and/or (iii) performing additional diligence (e.g. internet searches) related to outside business activities. The outside business activities and any changes related to them should be periodically re-evaluated to determine whether, for instance, a change in the outside business activities has occurred to make a conflict of interest more acute or there has been a change in the fund sponsor's business or business relationships that present new conflicts or make an existing non-material conflict of interest material.

4. *Resolve Policy Violations.* If a fund sponsor becomes aware that an employee has begun to engage in outside business activities without prior approval, it should require the employee to cease the outside business activities until further review is conducted and should consider sanctioning the employee. We note that, as in the Firm's situation, outside business activities of employees of private fund sponsors often involve personal investing. If an employee's outside business activities involve investment in a business, the employee may have also violated the fund sponsor's code of ethics, which, in accordance with the 1940 Act and the Advisers Act must contain a requirement that certain employees obtain the fund sponsor's approval before they acquire beneficial ownership of any security in a limited offering.<sup>1</sup>
5. *Report Conflicts of Interest to Personnel Responsible for Disclosure Documents.* If the person(s) responsible for deciding that an outside business activity is permissible are different than the personnel responsible for the fund sponsor's and/or the funds' disclosure documents (e.g., Form ADV, private placement memorandum, prospectus and statement of additional information), the person(s) who approved the outside activity should ensure that those responsible for disclosure documents are aware of the approved outside business activity and the conflicts of interest it presents and work with those individuals to ensure that adequate disclosure, if necessary, is added to the relevant documents. For registered fund sponsors, in addition to written disclosure obligations, the fund sponsor should have a process in place to consider whether disclosure to the board of directors of the registered fund is also advisable, regardless of whether written disclosure documents are updated.

The foregoing recommendations are not hard and fast rules and are intended to serve as a guideline to approaching outside business activities of fund sponsor employees. While the major considerations may be the same, each circumstance will generally merit a customized approach.

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<sup>1</sup> See Advisers Act Rule 204A-1(c) and 1940 Act Rule 17j-1(e).

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