# Manager Insight

**October 10, 2017**

## Private Fund Advisers Must Apply a Consistent, Transparent Approach to Conflicts of Interest

A recent Securities and Exchange Commission (SEC) enforcement action reminds investment advisers to be conscious of potential conflicts of interest throughout the investment process. Specifically, fund managers must ensure that policies and procedures relating to conflicts of interest are established and consistently complied with and that compliance with those policies and procedures is documented.

In July 2017, the SEC settled an enforcement action against Paramount Group Real Estate Advisor LLC (Paramount), a registered investment adviser, relating to alleged violations of Sections 206(2) and 206(4)[1] of the Investment Advisers Act of 1940.[2] The enforcement action arose out of an examination of Paramount by the SEC's Office of Compliance Inspections and Examination (OCIE), who involved the SEC's Division of Enforcement in a discussion of OCIE's examination findings.

Paramount served as investment adviser to Paramount Group Real Estate Fund III, L.P. (Fund III), a real estate investment fund formed in 2005. Fund III's investment portfolio included an office tower and garage in San Francisco. Paramount determined that the garage portion of the property would be more valuable if redeveloped as a residential tower. However, Fund III was past its investment period and did not have sufficient capital to fund a long-term development project. Moreover, residential development was outside of Fund III's investment strategy. So in mid-2013 Paramount formed Paramount Group Residential Development Fund, L.P. (RDF) for the purpose of purchasing and developing the garage property.

Fund III's organizational documents established an investor advisory committee (the "IAC") with authority to review potential conflicts of interest. The IAC approved the sale of the property to RDF for no less than $45 million and on the condition that development costs incurred by Fund III prior to the sale of the property, including re-zoning expenses, be reimbursed by RDF. Paramount also gave Fund III's investors the right to invest in RDF.

The garage also served as collateral for loans against the entire property. The lenders required that the garage be sold for no less than the average of the highest two of three independent appraisals. Independent appraisals obtained by Paramount valued the garage at $49 million, $56 million, and $73.1 million. Unlike the first two, the third appraisal was based on the garage's ability to obtain zoning changes that would allow it to be developed as a residential property as planned. Following the appraisal process, Paramount decided not to cause RDF to reimburse Fund III for re-zoning expenses incurred by it before the sale. Paramount believed that the higher purchase price for the garage adequately reflected the increased value associated with the re-zoning, and related

[1] Section 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act") prohibits investment advisers from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(4) of the Advisers Act prohibits investment advisers from engaging in "any act, practice, or course of business which is fraudulent, deceptive, or manipulative."
[2] The full SEC release can be found here: https://www.sec.gov/litigation/admin/2017/ia-4726.pdf

expenses, because one of the appraisals used to calculate the purchase price effectively assumed the re-zoning would be obtained. Paramount did not disclose this determination to the IAC or Fund III's investors prior to the sale, though removal of the reimbursement obligation was later reflected in Fund III's financial statements.

Paramount and its affiliates owned a much larger piece of RDF (26.7%) than it did of Fund III (3%). The SEC's release specifically notes that this difference caused a conflict of interest. Consequently, Paramount could not consent to the removal of the reimbursement requirement on behalf of Fund III or its investors. Notwithstanding that one of the appraisals used by Fund III may have accounted for the reimbursable expenses, violating the reimbursement condition created the appearance that RDF could have benefited at the expense of Fund III. That is, even if Paramount's determination was ultimately economically reasonable, the SEC made clear that Paramount's fiduciary duty applies without regard to the economic result, and the appropriate response would have been to go back to the IAC for approval.[3] As demonstrated in this case and in prior enforcement actions, a "no harm, no foul" approach to conflicts of interest will not withstand SEC scrutiny.[4]

The SEC's release does not specify whether: (1) the IAC held the exclusive authority to review conflicts of interest; (2) Fund III's general partner was bound by the IAC's recommendations; (3) Fund III's general partner was obligated to bring each potential conflict of interest to the IAC; or (4) RDF's organizational documents contained similar conflicts of interest requirements, though given RDF's special purpose nature, they may not have. In many private investment fund partnership agreements, advisory committee approval is a means of clearing conflicts of interest with investors, but it is not always required. If that was the case with Fund III, Paramount may not have been obligated by the terms of the document to obtain IAC or investor consent to the transaction between RDF and Fund III. However, by seeking initial approval by the IAC and later completing the sale without the reimbursement of expenses, Paramount ran the risk of misrepresenting the terms of the transaction to its investors.

Private investment fund managers regularly encounter issues of timing and fit with respect to investments—a particular opportunity may not fall within the fund's strategy, or the fund's investment period or term (or remaining capital commitments) may effectively preclude the manager from making follow-on investments or raising needed co-investment capital. In resolving these issues, investment advisers must address conflicts of interest not merely for the sake of legal compliance. Rather, advisers should view conflicts of interest as a factor in their broader approach to investment risk. This factor can be minimized by establishing and consistently complying with clear conflicts of interests policies and procedures, including, as appropriate, complete, advanced disclosure to investors or an investor committee, and carefully documenting such compliance.

[3] As noted above, the full details of the transaction were not disclosed to investors until well after it was completed. It is not clear whether prior disclosure would have protected Paramount from regulatory scrutiny, although the SEC release also states that the post-closing disclosure "did not constitute obtaining the [IAC's] consent."

[4] For instance, in 2016, the SEC settled an enforcement action against a private equity fund manager, in which the SEC alleged, in part, that the reimbursement, with interest, of certain unauthorized expenses did not fully remediate a conflict of interest. For a discussion of this settlement, see http://www.hf-law.com/news-events/news/sec-enforcement-action-underscores-need-to-evaluate-brokerage-activities-of.

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