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# Private Equity Alert

## Prominent Investment Adviser and Former Chief Compliance Officer Settle SEC Enforcement Action Arising from Failure to Disclose Conflict of Interest Regarding Outside Business Activities

*By David Wohl and Venera Ziegler*

BlackRock Advisors, LLC ("BlackRock") and its former chief compliance officer (the "CCO") recently settled an enforcement action brought by the Securities and Exchange Commission (the "SEC") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and the Investment Company Act of 1940, as amended (the "Investment Company Act"). The SEC alleged, among other things, that (i) BlackRock, in violation of its fiduciary duty, failed to disclose to its clients a material conflict of interest concerning the outside business activities of one of its portfolio managers (the "PM") and (ii) BlackRock failed to adopt and implement policies and procedures regarding outside activities of employees in violation of Rule 206(4)-7 under the Advisers Act, and the CCO caused such failure.

According to the SEC's order instituting a settled administrative proceeding, the PM was managing energy-focused mutual funds, private funds and separately managed accounts at BlackRock when he founded a family-owned and -operated oil and natural gas company (the "Outside Business"). The PM was the general partner (and his three sons were executive officers) of the Outside Business and he personally invested approximately $50 million in it. The Outside Business formed a joint venture with a publicly-traded coal company ("ANR") that eventually became the largest holding (almost 10%) in one of the BlackRock mutual funds managed by the PM, as well as an investment of various BlackRock private funds and managed accounts he advised. The SEC's order found that BlackRock knew and approved of the PM's investment and involvement with the Outside Business as well as the joint venture, but failed to disclose this conflict of interest to BlackRock's advisory clients and therefore breached its fiduciary duty to those clients. In its order, the SEC stated:

> *As an investment adviser, BlackRock has a fiduciary duty to exercise the utmost good faith in dealing with its clients – including to fully and fairly disclose all material facts and to employ reasonable care to avoid misleading its clients. It 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. BlackRock breached its fiduciary duty by failing to disclose to the funds' boards and advisory clients the conflict of interest created when BlackRock permitted [the PM] to form, invest, and participate in*

> *an energy company while [the PM] was also managing several billion dollars in energy sector assets held in BlackRock funds and separate accounts. The conflict of interest became more acute once [the Outside Business] finalized its joint venture with ANR, as the [PM]-managed funds and separate accounts held significant positions in ANR stock.*

The SEC's order also found that BlackRock failed to adopt and implement policies and procedures for outside activities of employees as required by Rule 206(4)-7 under the Advisers Act, and the CCO caused this failure. BlackRock did have a policy that required pre-approval for an employee to serve on a board of directors and had a general conflicts of interest provision in its Code of Business Conduct and Ethics (the "Code") that addressed conflicts or potential conflicts that could arise from the personal activities or interests of BlackRock employees. Pursuant to the Code, BlackRock required all conflicts and potential conflicts to be reported to a supervisor, manager, or a member of BlackRock's Legal and Compliance Department. BlackRock failed, however, to adopt and implement policies and procedures that addressed how the outside activities of BlackRock employees were to be assessed for conflicts purposes, as well as who was responsible for deciding whether the outside activity should be permitted. BlackRock also failed to adopt and implement policies and procedures to monitor those employees with BlackRock-approved outside activities, so that BlackRock would stay informed about any changes in the employee's outside activity and re-evaluate it, if necessary. The SEC stated that the CCO was responsible for the design and implementation of BlackRock's Advisers Act compliance policies and that he knew and approved of numerous outside activities engaged in by BlackRock employees (including the PM), but did not recommend written policies and procedures to assess and monitor those outside activities and to disclose conflicts of interest to clients. As such, the SEC stated that the CCO caused BlackRock's failure to adopt and implement these policies and procedures.

While BlackRock and the CCO neither admitted nor denied the SEC's findings, as part of the settlement BlackRock agreed to be censured and BlackRock and the CCO consented to the entry of the SEC's order finding various violations of the Advisers Act and the Investment Company Act. BlackRock agreed to pay the SEC a civil penalty of $12 million and the CCO agreed to pay $60,000. Finally, BlackRock agreed to hire an independent consultant to review its policies and procedures regarding outside activities of employees and conflicts of interest created thereby.

In light of this proceeding, investment advisers should insure that they have comprehensive and robust policies and procedures regarding (i) the nature of permitted outside activities of employees, (ii) who within the organization is responsible for deciding whether outside activities are permitted, (iii) how such activities will be assessed for potential or actual conflicts of interest and whether specific disclosure regarding such conflicts should be given to clients and (iv) the ongoing monitoring of outside activities so that the adviser can continually evaluate whether the activities continue to be appropriate. Furthermore, the SEC's action highlights the very real risks a chief compliance officer of a registered investment adviser faces if he or she fails to identify and act upon material conflicts of interest that could negatively impact clients.

***Private Equity Alert*** is published by the Private Equity practice group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, www.weil.com.

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