Taking ‘Private’ Out of Private Equity: 7 SEC Focus Areas

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In 2012, the U.S. Securities and Exchange Commission’s Office of Compliance Inspections and Examinations commenced its Presence Exam initiative in response to the provisions of the Dodd-Frank Act, which required many large and mid-size private equity firms to register with regulators. Since then, the office has been active in its efforts to gain insight into the historically “closed” world of private equity, and there is no indication the pressure will subside anytime soon.

Here, we present recent SEC developments and highlight seven key areas in which we believe private equity firms and their advisers can expect increased focus.

Renewed Focus on Private Equity Activity

The SEC has been flashing warning signs for quite some time about its intent to monitor private equity firm activity, particularly in the area of expense allocation. In January 2013, for example, Bruce Karpati, then chief of the Enforcement Division’s Asset Management Unit, addressed the PE International Conference, stating that the misallocation of fund expenses would be viewed as misappropriation by the SEC.

In a well-publicized speech, “Spreading Sunshine in Private Equity,” at the Private Equity International (PEI) Private Fund Compliance Forum in May 2014, former OCIE Director Andrew Bowden highlighted the office’s interest in seeking a better understanding of the private equity industry. He also shared early insights from the OCIE presence examinations of private equity advisers, which began in October 2012.

More recently, this past May, acting OCIE Director Marc Wyatt updated the SEC’s efforts. Wyatt noted that, while there have been some positive changes since

the "Sunshine" speech, including increased focus by investors on fees and expenses, enhanced general partner (GP) disclosure practices and enhanced due diligence procedures by limited partners (LPs), there is still plenty of opportunity to improve how private equity firms operate, market and present their results to investors and the general public.

In addition, Bowden's remarks on the importance of a culture of compliance supported by the owners and principals of the firm, which is reinforced through an independent, empowered compliance department, have not been lost.

Walking the Talk

With respect to private equity compliance, the OCIE has been walking the proverbial "walk" to back up its enforcement talk. The SEC formed a private funds unit (PFU) to conduct presence exams. The PFU comprises experienced examiners charged with looking over the often complex and illiquid investments owned by private equity firms, which tend to be difficult to value. The PFU's team of examiners advances the OCIE's four pillars, which include: (1) promote compliance; (2) monitor risk; (3) detect fraud; and (4) inform policy. They review marketing materials for inconsistencies and misrepresentations, including performance marketing, use of projections and misstatements about investments and, according to a recent Reuters report, how private equity firms calculate and report net internal rate of return (IRR) disclosures on new funds to investors.[1]

Given the SEC's well-known history in following up statements made in public speeches with enforcement actions, private equity firms can anticipate an uptick in regulatory action. There have been a number of enforcement actions and settlements, including most notably:

In February 2014, the SEC brought an action against Clean Energy Capital, LLC,[2] which it touted as the "first action arising from a focus on fees and expenses charged by private equity firms." The SEC charged the fund and its manager with, among other things, assigning general expenses to the funds and improperly allocating expenses amongst the various funds managed by the master fund. Specifically, the SEC alleged that the firm's management company improperly charged $3 million in expenses, including its own rent and compensation and benefits of management company employees, to funds.

Following the Clean Energy case, the SEC took action against Lincolnshire Management, and the fund agreed to pay $2.3 million to settle charges that it improperly allocated expenses between the investments of two of its funds, which both owned a stake in what was, essentially, the same company.[3]

In April of this year, the SEC charged the investment manager of Alpha Titans, LLC with: (1) breaching its fiduciary duty by using fund assets to pay adviser-related operating expenses, such as employees' salaries and health benefits, rent, parking, utilities, computer equipment, technology services and other operational costs; (2) distributing materially misleading financial statements for the funds that inadequately and incorrectly described the total amount of expenses paid by the funds and the related-party relationships; and (3) failing to disclose the absorption of certain expenses by the funds as compensation received by the adviser.[4]

Most recently, private equity giant KKR has agreed to pay $30 million (including a $10 million penalty) to settle accusations that it passed along expenses related to unsuccessful buyouts ("broken deals") to the funds of its limited partners, thus, breaching its fiduciary duty to those funds.[5]

Defense by Offense: Preparing for an Information Request or Potential Exam

In a perfect world, private equity firms would proactively conduct assessments of in-house compliance programs. This would include developing robust programs and controls for processing and reporting functions, as well as periodic reviews and updates to those controls. The benefits of such reviews are many, but perhaps the most important is the early identification of areas of compliance risk. If the compliance review is conducted properly, it is possible to remediate such risks before they become potential matters subject to regulatory action or third-party litigation. Moreover, in the event of an external inquiry, the fund's "house" will be in order to withstand any future inquiries.

Constraints on financial and human capital, however, often make it difficult for firms to carry out such a task. Therefore, firms often discover potential issues when responding to compliance inquiries raised by interested parties, such as investors or regulators. These requests can be benign and informal, such as a request for information or, in the worst case, the result of an SEC sweep of a particular issue.

Responding to a request for information, subpoena or regulatory inquiry will potentially require the PE firm or fund manager to retrieve information from myriad sources, including financial systems and third parties. This is a disruptive event that will almost certainly consume time and resources that, as previously noted, most firms cannot afford. In addition, responding to an inquiry with incomplete information or too much information can create further waste or other unnecessary complications for both the fund and the PE firm itself.

An appropriate and measured response often requires the experience of outside counsel working with experts who are skilled in responding to regulator requests. However, performing an analysis of the design, development and testing of compliance programs that address the highest risk areas is generally more cost-effective and efficient.

Accordingly, we believe most advisers should be, at a minimum, developing compliance programs that address governance at the adviser level, and cover and apply to each fund manager. They should also perform periodic reviews of seven key areas that may be of specific importance to regulators:

Area of Concern	Action(s) to Address
1. Failure to implement robust compliance programs with controls and disclosures that meet and match investor expectations.	• Implement a compliance and controls program based on a recognized and validated framework (e.g., COSO), which uses a risk-based approach to assess the areas advisers and funds can run afoul of relevant laws. • Develop a well-resourced and trained compliance staff led by an empowered chief compliance officer with knowledge of applicable rules and regulations. • Develop an accounting system designed to record information in a reasonable manner.

Area of Concern	Action(s) to Address
2. Limited partner agreements that: a) Are overly broad or vague with respect to the characterization of fees to be charged to portfolio companies, as opposed to those required to be borne by the fund adviser; b) Lack of clearly defined valuation procedures, investment strategies and protocols for mitigating certain conflicts of interest, including investment and co-investment allocations; and c) Insufficient information rights preventing limited partners from monitoring not only the investments, but also the adviser's operations.	• Review fund documents and policies and procedures against current practices to ensure consistency with current practices. • Review valuation policies and procedures for adequacy, reasonableness and clarity of valuation methodologies and performance calculations. • Review provisions pertaining to fees and expenses charged to investors to ensure they are clear with respect to the allocation of the fees. Provisions should not create ambiguity with respect to which fees and expenses will be incurred by the adviser as opposed to the fund and portfolio companies.
3. "Zombie" managers, who oversee existing funds past their expected life, continue to charge fees, improperly shift expenses to the funds, or issue improper valuations in marketing materials.	• Review fund documents and provisions for term violations. Review all fees and disclosures associated with such funds for proper allocation and disclosures.
4. Separate accounts and co-investments that invest alongside funds instead of more traditional single commingled funds, which may not allocate broken deal expenses or other costs associated with generating deal flow because the adviser either lacks the capital to manage or has failed to update its policies and procedures to manage separate accounts.	• If using separate accounts or co-investment vehicles, determine expense allocation methodology and update policies and procedures, if necessary.
5. Improper use of "operating partners," who are part of the adviser's general team and who provide consulting or other services to portfolio companies. Such operating partners are not typically employees of the adviser, but are hired by and charged to the portfolio companies.	• Review disclosures related to operating partners, including identity of partners and adequacy of explanation of costs. • Review disclosure made in all documents prepared by the fund partners to ensure robustness and consistency of disclosures related to material items, such as conflicts of interest, fees, etc.
6. Improper shifting of general back-office expenses (e.g., reporting, compliance, legal and accounting) from the advisers to the fund or portfolio companies without sufficient disclosure.	• Review and test all fees and expenses charged to funds to ensure overhead and similar general fund expenses are not charged to specific funds. • Review and test all fees and expenses with respect to the corresponding fund(s) to ensure they are appropriately supported and documented.

Area of Concern	Action(s) to Address
7. Charging of hidden fees, which have not been adequately disclosed to limited partners, such as: a) "Monitoring" fees charged to portfolio companies by advisers in exchange for board and other advisory services during the portfolio company's holding period, which ran for a longer duration than the fund's term, self-renewed annually or had an indefinite term; b) Undisclosed "administrative" or other fees not contemplated by the limited partnership agreement; c) Exceeding limits for transaction fees or charging transaction fees not contemplated by the limited partnership agreement; and d) Fees charged by third-party service providers hired by the adviser, who deliver services of questionable value.	• Review and test all fees and expenses with respect to corresponding fund(s) to ensure they are appropriately supported and documented.

Overall, private equity partners should be wary of the SEC's interest in their operations and take a proactive approach to address these and other areas of potential interest. This will likely ensure a more positive outcome in the case of any regulatory inquiry.

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[1] SEC probing private equity performance figures, Reuters, 10/29/2014.

[2] In re Clean Energy Capital LLC et. al., SEC Release No. 33-9667 (Feb. 25, 2014); http://www.sec.gov/litigation/admin/2014/33- 9667.pdf

[3] In re Lincolnshire Management Inc., SEC Release No.IA-3927 (Sept. 22, 2014); http://www.sec.gov/litigation/admin/2014/ia-3927.pdf

[4] In re Alpha Titans LLC et al., SEC Release No.34-74828 (Apr. 29, 2015); http://www.sec.gov/litigation/admin/2015/34-74828.pdf

[5] In the Matter of Kohlberg Kravis Roberts & Co. LP, SEC Release No. 3-16656 (June 29, 2015); http://www.sec.gov/litigation/admin/2015/ia-4131.pdf

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