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Spreading Sunshine or Shining a Spotlight?

By Jay G. Baris and Kelley A. Howes

In a recent speech, Andrew Bowden, Director of the SEC's Office of Compliance Inspections and Examinations (OCIE) "spread sunshine" on private equity industry practices gathered through so-called "presence exams" of newly registered private fund advisers.

The goal, he said, is to help these advisers spot potential issues before they find themselves in regulatory hot water. But the "sunshine" may be more like a giant spotlight on private fund advisers, with some storm clouds rolling in on the horizon.

Bowden's remarks sounded some familiar themes. Key among them: transparency and clear disclosure are the surest way to mitigate conflicts of interest. The unique business model of private equity funds, however, presents unique risks that firms should address.

For example, he said, private equity funds generally use client funds to obtain a controlling interest in privately traded companies. The relative paucity of disclosure and transparency of these investments, however, may present private fund advisers with conflicts that advisers of registered funds do not face.

Among other things, Bowden said, OCIE is concerned about how fees and expenses are allocated between the adviser and the fund, and how allocations are disclosed to investors. OCIE is also concerned about lack of clear disclosure regarding valuation procedures, investment strategies and protocols for mitigating conflicts of interest, including investment and co-investment allocations.

FEES AND EXPENSES

One area of significant focus for OCIE is how private equity advisers collect fees and allocate expenses. Bowden said that in more than 50% of the presence exams conducted to date, OCIE has identified what it believes are "violations of law or material weaknesses in controls" in how fees and expenses are handled by private equity advisers.

Shifting fees. Bowden said that OCIE has identified arrangements that shift fees or expenses from the adviser to the investor, but are not fully disclosed to investors and therefore investors may not expect. These include, for example:

- *The use of consultants or "Operating Partners."* Bowden said that a growing practice involves the use of "Operating Partners," who provide portfolio companies with consulting services that they could not otherwise afford. OCIE's concern is that these independent consultants "look and act just like other adviser employees," but "it is the investors who are unknowingly footing the bill for these resources," on top of management fees paid to the adviser.

- *Shifting fees without disclosure*. OCIE has identified a trend of advisers shifting expenses from themselves to their clients well into a fund's life without adequate disclosure. For example, service providers originally characterized as the adviser's employees may reappear later as "consultants" paid by the fund.

- *Shifting administration expenses.* OCIE has identified a practice of advisers using "process automation" to shift expenses to fund shareholders without adequate disclosure. For example, by having the funds pay for automated reporting systems, the advisers avoid the cost of preparing reports that their own employees prepared in the past.

Hidden fees. In addition to shifting fees, Bowden said that OCIE is concerned that private equity funds and their advisers are charging hidden fees without adequate disclosure. These fees include:

- *Accelerated monitoring fees.* Advisers commonly charge "monitoring fees" to portfolio companies for providing board and other advisory services during a portfolio company's holding period. OCIE has found, however, that some advisers have their portfolio companies sign monitoring agreements that obligate them to pay monitoring fees for 10 years or more, although the typical holding period lasts about five years. Some of these arrangements, he said, run past the term of a fund, and exit strategies employed by a fund may trigger large accelerated payments.

- *Undisclosed administration fees.* OCIE has identified a practice of advisers charging undisclosed administrative fees not originally contemplated by a limited partnership agreement.

- *Exceeding expense limits.* OCIE cited a trend of exceeding transaction fee limits set in a limited partnership agreement, or charging transaction fees not contemplated by limited partnership agreements as another troubling hidden-fee practice.

- *Affiliated service providers.* OCIE has observed a practice of advisers requiring funds to enter into arrangements with related parties that provide services of "questionable value" to the fund.

MARKETING AND VALUATION

Another ongoing and familiar concern relates to marketing and valuation. Bowden said that OCIE has observed that some private equity advisers use valuation methodologies that are not consistent with disclosures to investors.

Bowden noted that OCIE examiners do not seek to second-guess fair value assessments, but rather want to ensure that advisers use valuation processes that align with what they promise to investors. He said that examiners are looking for, among other things:

- cherry-picking comparables or adding back inappropriate items in EBITDA without a rational reason or disclosure to investors; and

- changing a valuation methodology from period to period without disclosure to investors.

Marketing materials are also coming under the microscope; in particular, those that advertise performance using projections instead of actual valuations and situations when key team members resign or announce a reduced role soon after fundraising is complete.

According to Bowden, there is work to be done to bring private equity advisers' controls and disclosures in line with regulatory requirements and investor expectations. In short, he said, it is not sufficient to just comply with the letter of the law; firms must also treat clients and investors "fairly, equitably, and in accordance with [their] status as [fiduciaries]."

Contact:

Jay G. Baris
(212) 468-8053
JBaris@mofo.com

Ken W. Muller
(415) 268-6029
KMuller@mofo.com

Charles S. Farman
(916) 325-1309
CFarman@mofo.com

Chip L. Lion III
(650) 813-5615
PLion@mofo.com

Kelley A. Howes
(303) 592-2237
KHowes@mofo.com

Isabelle Sajous
(212) 336-4478
ISajous@mofo.com

Stephanie C. Thomas
(916) 325-1328
SThomas@mofo.com

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