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SEC Warns Private Equity Fund Advisers about Compliance Shortcomings

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Andrew J. Bowden, Director of the Securities and Exchange Commission's **Office of Compliance Inspections and Examinations** (OCIE) delivered remarks at last week's **Private Equity International (PEI) 2014 Compliance Forum** that all private equity fund advisers should be aware of. In his speech, titled "Spreading Sunshine in Private Equity," Director Bowden described multiple areas in which OCIE examiners have observed deficiencies in private equity advisers fulfilling their obligations under the Investment Advisers Act of 1940 (Advisers Act).

The speech puts private equity advisers on notice that the SEC will be paying very close attention to these issues in current and future examinations. *Private equity fund advisers are strongly urged to review their compliance procedures and fund documents to ensure they are complying with their obligations under the Advisers Act.*

Background

As a result of the **2010 Dodd-Frank Act**, many advisers to private equity funds are now required to register with the SEC, thereby subjecting them to periodic examination by OCIE. In October of 2012, the OCIE commenced its "Presence Exam Initiative," which was designed to establish a presence with the private equity industry and better assess issues and risks presented by its business model. Over the past two years, OCIE examiners have initiated the examination of more than 150 newly registered private equity advisers and expect to examine 25% of the new private fund registrants by the end of 2014. Through these examinations, OCIE has found a number of areas where it believes private equity fund advisers are *consistently* failing to fulfill their obligations under the Advisers Act.

Key OCIE Concerns

Key areas identified by Director Bowden include:

Private Equity Business Model

Director Bowden noted that the private equity business model has inherent risks and conflicts of interest that many other advisers do not have. Because private equity funds frequently obtain controlling interests in privately held companies, there is a heightened potential for conflicts to arise.

Limited Partnership Agreements

Director Bowden states that many limited partnership agreements are vague and ambiguous in certain key areas, which can cause significant problems. Agreements may, among other things, (i) contain "enormous grey areas" with respect to the fees and expenses that can be charged to the LPs or portfolio companies; (ii) have poorly defined valuation procedures; and/or (iii) only vaguely describe procedures for co-investment allocation. Ambiguous limited partnership agreements can contribute to a lack of transparency with investors and a failure to comply with disclosure requirements under the Advisers Act.

Fees and Expenses

Director Bowden is particularly troubled by a lack of transparency regarding the fees and expenses borne by portfolio companies and their limited partners. Problem areas with respect to fees and expenses include:

- **Co-investments**
  Allocation of transaction-related fees and expenses (including break-up fees) to a commingled fund, but not co-investors and separate accounts involved in the transaction;
- **Operating Partners**
  Charging "operating partner" salaries and overhead to the fund or portfolio company, while

simultaneously presenting operating partners as members of the adviser's team, leading investors to believe they are paid by the adviser;

- **Shifting Expenses from GP to LP**
  Shifting expenses from the adviser to a commingled fund, including terminating adviser employees and rehiring them as third-party consultants, and billing the fund for back-office activities typically borne by advisers; and
- **"Hidden" Fees**
  Receiving "hidden" fees, such as monitoring fees, under agreements that are not adequately disclosed to investors, whose duration may exceed the fund's expected life or that charge significant early termination fees upon a change of control.

Valuation

The OCIE has observed compliance risks surrounding marketing and the valuation of portfolio companies, such as (i) inflated valuations during periods of fundraising; (ii) using valuation methodology different from the methodology described in fund materials; (iii) inappropriate accounting maneuvers (*e.g.* adding back items to EBITDA); (iv) changing methodologies from one period to another; (v) cherry-picking comparables; and (vi) using projections instead of actual valuations.

Conclusion

The OCIE has advised private equity advisers of several specific areas where it has found shortcomings with respect to compliance obligations under the Advisers Act. Advisers to private equity funds therefore are urged to review their existing practices, develop a thorough compliance program, and build a culture of compliance, including by designating a chief compliance officer and integrating the compliance function into the firm's business. Venable attorneys can help private equity fund advisers ensure that they are in compliance with the Advisers Act and avoid the issues described above. If you would like to discuss having Venable perform a risk assessment for your firm, or if you have any other questions, please contact any of the authors of this article.

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