

# Private Equity Alert

## OCIE Director Shares Observations From Recent SEC Examinations of Private Equity Advisers

By David Wohl and Venera Ziegler

On May 13, 2015, in a speech at the PEI Private Fund Compliance Forum, Marc Wyatt, Acting Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), shared some observations a year after Andrew Bowden<sup>1</sup> announced the SEC's findings from its examinations of private equity advisers in his "Spreading Sunshine in Private Equity" speech (the "Sunshine Speech").<sup>2</sup> The highlights from Mr. Wyatt's presentation are as follows:

- **SEC's Observations Following the Sunshine Speech.**
  - *Investor Focus:* Following the Sunshine Speech, investors have increased their focus on fees and expenses, emphasizing transparency, governance and access to information when negotiating their investments in private equity funds.
  - *Operating Partners:* In the Sunshine Speech, Mr. Bowden explained that many advisers did not have appropriate disclosure with respect to operating partners whose compensation is separate from, and in addition to, the management fee and carried interest paid by the fund to the adviser. Following the Sunshine Speech, advisers increased their disclosure with respect to operating partners to their investors, more clearly defining the role of the operating partners and the sources of their compensation.
  - *Accelerated Monitoring Fees:* The SEC has noticed a decline in the use of portfolio company monitoring and similar fees which may be accelerated upon the sale or initial public offering of the portfolio company. When asked whether the SEC would be less concerned by acceleration to the extent such fees are subject to a 100% management fee offset, Mr. Wyatt and Mr. Igor Rozenblit, co-head of OCIE's private funds unit, stated that the offset would not necessarily resolve the issue since these fees still can be material at the end of the fund's life because there may not be sufficient management fees available to offset the accelerated amount.
- **Areas Where the SEC Believes There is Room For Improvement.**
  - *Fees and Expenses:* Although there has been improvement in this area, the SEC still finds that many advisers have inadequate methodologies, policies and procedures and/or disclosure relating

to fund expenses and expense allocation. Advisers must ensure that expenses passed on to their investors are consistent with their fiduciary duties. Many advisers have added more disclosure of fees and expenses in Part 2A of Form ADV. However, Mr. Wyatt stated that disclosure alone is not a sufficient remedy for absence of disclosure prior to a fund's closing. Mr. Wyatt suggested that in certain circumstances it may be appropriate for private fund advisers to amend their partnership agreements with the consent of limited partners to reflect current practices.

Some of the most common deficiencies found in this area involve improper allocation of expenses regarding parallel funds created for insiders, friends and family and preferred investors. The SEC has found that operating expenses, broken deal expenses and formation expenses of side-by-side vehicles are often improperly shifted to the main fund.

- **Co-Investments.** The SEC has increased the attention it pays to co-investment arrangements with investors and whether such arrangements are dealt with in a fair way. The SEC has found that there are instances where co-investment priority arrangements are not disclosed to all investors. In addition, co-investments have been allocated in a manner contrary to what has been promised to investors, which the SEC views as a material conflict and potential violation of federal securities laws. Advisers are encouraged to maintain robust and detailed co-investment allocation policies which should be disclosed to all investors so that all investors are aware of their position in respect of the co-investment process.
- **Real Estate Advisers.** The SEC is expanding its focus beyond traditional buyout funds into real estate, credit and infrastructure funds. The SEC has observed that real estate advisers, especially those executing opportunistic and value-add strategies, tend to be more vertically integrated than traditional private equity advisers. After buying a property, it is

not unusual for a vertically integrated owner-operator investment adviser to provide property management, construction management, and leasing services for additional fees. The SEC has observed that some advisers also charge back to the fund the cost of their employees who provide asset management services and their in-house attorneys. The SEC found that sometimes these ancillary services and fees are not disclosed to investors, or, even if investors have allowed the adviser to charge these additional fees based on the understanding that the fees would be at or below market rate, advisers were not always able to justify that such fees were in fact below market rate.

- **Looking Ahead.**

- Mr. Wyatt stated that it is reasonable to assume that the near future may bring additional enforcement actions against private equity advisers by the SEC's Division of Enforcement involving undisclosed and misallocated fees and expenses and conflicts of interests. Mr. Wyatt again emphasized the importance of transparency and full disclosure to investors.
- In light of Mr. Wyatt's speech and the SEC's focus on these issues, private equity advisers should review their existing disclosure and compliance policies and procedures to ensure that their practices in these areas match their disclosure and are consistent with their fiduciary obligations to their clients. In addition, advisers should maintain appropriate documentation to enable them to prove that their actions in these areas are consistent with their policies and procedures and their fiduciary duties.

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1. Mr. Bowden is the former Director of OCIE.
  2. For more information on the Sunshine Speech please see our May 2014 Private Equity Alert "SEC Official Remarks on Recent OCIE Findings From Private Equity Fund Examinations" available at [http://www.weil.com/~media/files/pdfs/may\\_12\\_2014\\_pe\\_alert.pdf](http://www.weil.com/~media/files/pdfs/may_12_2014_pe_alert.pdf).

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