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Private Equity Alert

SEC Official Remarks on Recent OCIE Findings From Examinations of Private Equity Advisers

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On May 6, 2014, in a speech at the PEI Private Fund Compliance Forum, Andrew Bowden, Director of the SEC's Office of Compliance Inspections and Examinations, presented a detailed accounting of what the SEC has found in its examinations of more than 150 private equity advisers that have registered since 2012. The highlights from Mr. Bowden's speech are as follows:

- **Partnership Agreements.** Mr. Bowden stated that many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies and the funds as opposed to being borne by the adviser. Private equity advisers should review their partnership agreements to ensure that fees and expenses are properly characterized and allocated. Mr. Bowden also stated that partnership agreements are often lacking clearly defined valuation procedures, investment strategies and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.
- **Fees and Expenses.** The SEC found that over 50% of the examined advisers have inadequate policies and procedures or inadequate disclosure relating to fund expenses or have shifted expenses from the adviser to the fund during the middle of the fund's life without proper disclosure to investors.
    - Operating Partners - Some of the most common deficiencies in this area occur in the advisers' use of operating partners. Many operating partners are not employees of the adviser; rather, they are hired to advise portfolio companies and are compensated either by the fund or by the portfolio companies. Absent appropriate disclosure, investors may not be aware that such operating partners' compensation is separate from, and in addition to, the management fee and carried interest paid by the fund and does not offset the management fee paid to the adviser.
    - Shifting Employee Expenses - Another common deficiency is that some advisers, without disclosure to their investors, have terminated the employment of certain of their employees after the fundraising stage and have hired them back as consultants to their funds or

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- Weil advised Berkshire Partners and National Vision Inc., the leading independent retailer of eyeglasses and contact lenses, in the sale of National Vision to KKR
- Weil advised aPriori Capital Partners, a new independent advisory firm, in its spin-off from Credit Suisse and its management of DLJ Merchant Banking Partners
- Weil advised Baring Private Equity Asia in connection with the $3 billion take private of Giant Interactive Group, China's leading online game developer and operator

portfolio companies, thereby shifting the expenses related to such employees from the adviser to the fund or the portfolio company.

  - Accelerated Monitoring Fees - Mr. Bowden stated that many investors are not aware that portfolio company monitoring and similar fees may be accelerated upon the sale or initial public offering of the company. The effect of such acceleration, which in some cases may be worth millions of dollars, is to take assets out of the portfolio company prior to the fund's realization event. Therefore, sponsors engaged in this practice should clearly disclose it to investors prior to the time such acceleration occurs. While not mentioned by Mr. Bowden, we assume that the SEC would be less concerned by acceleration to the extent such fees are subject to a 100% management fee offset.

- **Valuation.** Mr. Bowden stated that the SEC has noted many cases where an adviser will use a valuation methodology different than the one disclosed to investors in connection with fundraising and other marketing initiatives.
  Mr. Bowden emphasized that the SEC generally is not in the business of second-guessing an adviser's valuation of an asset. However, advisers must clearly disclose to investors the valuation methodologies they will use, and should not change methods absent a rational reason.

- **Marketing.** Mr. Bowden cautioned advisers that the SEC was concerned with the use of performance projections in marketing materials without adequate cautionary disclosure, as well as improper or insufficient disclosure regarding management team members, especially situations where the adviser has reason to know that a team member may not stay in his or her current role after fundraising ends.

- **Rapidly Growing Advisers.** Mr. Bowden stated that the SEC has observed compliance issues with rapidly growing private equity sponsors, especially in situations where such growth is based on the creation of products such as separately managed accounts and co-investment vehicles. The SEC has found that such advisers' compliance functions often do not grow as fast as their business and, as a result, compliance problems arise. For example, Mr. Bowden noted that separately managed accounts and co-investment vehicles are often not allocated their share of broken deal expenses or other costs associated with generating deal flow. Therefore, private equity advisers should ensure that costs and expenses are allocated appropriately among their funds, separately managed accounts and co-investment vehicles.

In light of Mr. Bowden'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 duty to 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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