February 7, 2013

Private Equity Alert

SEC's Chief of Asset Management Unit Announces Increased Focus on Private Equity And Predicts More Enforcement Actions

By Christian Bartholomew and Jill Baisinger

On January 23, Bruce Karpati, Chief of the SEC's Asset Management Unit, spoke at a private equity conference. Based on Mr. Karpati's statements, it is clear that this Unit is focusing closely on private equity issues and that it will almost certainly bring more enforcement actions involving private equity. This change in approach appears to result from improved SEC expertise and the SEC's assessment of the current environment, which Mr. Karpati described as having too many managers chasing too little capital. Mr. Karpati also identified a number of factors that he believes contribute to the risk of fraud, including difficulties in valuing illiquid assets and certain incentive structures that are prevalent in the private equity sector.

As discussed in earlier *Private Equity Alerts*, http://www.weil.com/files/upload/Private_Equity_Alert_February_2012.pdf, the Asset Management Unit was formed in 2010, and focuses on investment advisers and investment companies, including managers of private equity funds. According to Mr. Karpati, the Unit has devoted substantial efforts to developing specialized knowledge of private equity issues. It has deepened its understanding of the private equity arena in part by working closely with other areas of the SEC (for example, the National Exam Program and the Division of Investment Management). Mr. Karpati also explained that the Unit has expanded substantive expertise through strategic hiring. The Unit has hired experts from hedge funds, mutual funds, and due diligence firms, and the Unit's "private equity specialist has been a deal professional executing transactions, as well as an LP performing manager selection at a large institution." Every member of the Unit has a specialty area and has generated a "detailed plan addressing either a type of investment vehicle or an investment practice." These efforts have put the SEC in a better position to understand and analyze private equity issues and practices.

With this specialized knowledge, the enforcement division has brought more private equity cases as well as hedge and registered fund cases involving "private equity-like issues." Mr. Karpati also predicted there would be an increase in such cases in the future. He identified the following specific concerns, many of which relate particularly to fundraising efforts and what Mr. Karpati described as "capital overhang":

Weil News

- Weil was ranked #1 in announced global private equity deals for 2012 with approximately 16.3% market share and $67 billion in deal value according to Bloomberg
- Weil was one of only three firms ranked in the top band for private equity in Chambers Global 2012 and one of only three firms ranked in the top band for private equity buyouts in IFLR 2013
- Weil advised Advent International in its acquisition of a majority interest in AOT Bedding Super Holdings, the parent company of National Bedding Company and Simmons Bedding Company
- Weil advised AMC Entertainment Holdings (a portfolio company of Apollo Global Management, Bain Capital, the Carlyle Group, CCMP Capital Advisors, and Spectrum Equity Investors) in connection with its $2.6 billion sale to Dalian Wanda Group
- Weil advised Centerbridge Partners in connection with its $1.1 billion take private acquisition of P.F. Chang's China Bistro
- Weil advised CVC Capital Partners in connection with its acquisition of a majority stake in Cunningham Lindsey, a major global loss adjusting and claims management firm, in a recapitalization transaction
- Weil advised Getty Images (a portfolio company of Hellman & Friedman) in connection with its $3.3 billion sale
- Weil advised Goldman Sachs Capital Partners in connection with the $2.3 billion sale of its portfolio company USI Insurance Services
- Weil advised Lion Capital in connection with its £1.2 billion sale of a 60% interest in Weetabix Food Co. to China's Bright Food Group
- Weil advised Ontario Teachers' Pension Plan (through its private equity group, Teachers' Private Capital) in connection with its acquisition of a majority interest in Heartland Dental Care

- **Aged funds.** Mr. Karpati contended that private equity funds have "long lives and investors have little ability to obtain liquidity." Mr. Karpati expressed his belief that older funds face a particular risk of fraud because investors typically become less involved over time and thus exercise less oversight over these funds.
- **A relatively large number of private equity funds with similar strategies facing a contraction in the amount of available new capital.** According to Mr. Karpati, "many managers around today will likely not be around 10 years from now—and many are even now fighting for their survival." Mr. Karpati believes that these factors encourage "aggressive" marketing and potentially "inappropriate behavior."
- **A lack of transparency, especially in valuing illiquid assets and in operations of portfolio companies.** Mr. Karpati emphasized that valuation problems assume particular importance during fund marketing, and he contended that the SEC has observed funds that "write[e] up assets during a fund raising period and then writ[e] them down soon after the fund raising period closes." On this point, he stressed that accurate interim valuations are particularly important to private equity investors.
- **Various conflicts of interest that are particularly prevalent in private equity.** As illustrations, Mr. Karpati described conflicts between the interests of management companies and investors: conflicts involving the shift of expenses and fees away from management companies; differential treatment of clients; and conflicts with managers' other businesses.

The Private Equity Initiative is one example of the SEC's efforts to identify and address issues particular to the private equity space. The Private Equity Initiative is an outgrowth of the Unit's overall "risk analytic initiatives," which try to locate "problematic conduct through the use of data and quantitative methods." As noted above, the SEC's "thesis" is that the large number of managers, the "current difficult fundraising environment," and the need for "steady private equity returns" will push certain managers out of the business. Mr. Karpati explained that, when managers can neither exit funds because of a lack of liquidity nor raise new capital, their

Weil News (continued)

- Weil advised Providence Equity Partners in connection with the C$1.1 billion acquisition of Canadian data center operator Q9 Networks by an investor group comprised of Providence, Ontario Teachers' Pension Plan, Madison Dearborn Partners, and BCE
- Weil advised Providence Equity Partners in connection with the acquisition by News Corporation of a 49% equity stake in the YES Network
- Weil advised Silver Lake Partners and Partners Group in connection with their €1.0 billion acquisition of Global Blue
- Weil advised Thomas H Lee Partners in connection with its acquisition of a majority stake in Party City Holdings in a recapitalization transaction valued at $2.7 billion

incentives shift from maintaining "good relations" with investors to maximizing their own revenue from the remaining assets. The Private Equity Initiative analyzes portfolios to identify funds with "unusually low liquidity" compared to peers (Mr. Karpati used the terms "zombie funds" and "zombie managers"). During subsequent examinations, the SEC searches for misappropriations from portfolio companies, fraudulent valuations, improper efforts to induce investors to grant extensions, unusual fees, and similar events that are viewed as particular risks for these types of funds.

Mr. Karpati closed the session by emphasizing the importance of COOs and CFOs, noting particularly their "absolutely critical" role in making sure that clients' interests are paramount. He reiterated the fiduciary duty imposed by the Investment Advisers Act of 1940 and explained that COOs and CFOs are "best positioned" to identify conduct inconsistent with that duty. Mr. Karpati contended that these officers are particularly important in the private equity sphere because "certain long held industry practices may be viewed as putting the manager's interest ahead of those of investors." Accordingly, he strongly encouraged the inclusion of COOs and CFOs in important decisions. Similarly, he recommended that private equity firms make use of their limited partnership advisory committees, which he described as an effective but often disregarded way to address potential conflicts of interest. In a particularly pragmatic point, he noted that doing so can help a firm demonstrate "good faith." More generally, Mr. Karpati encouraged companies to integrate compliance risk into overall risk management processes and to assign an "experienced deal professional" to participate in the process.

In short, Mr. Karpati's statements confirm that the SEC has devoted substantial resources to the Asset Management Unit and that this Unit is, in fact, focusing intensely on private equity issues. Accordingly, we do expect to see even more private equity enforcement actions in the future.

Private Equity Alert is published by the Private Equity Group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, http://www.weil.com.

The Private Equity Group's practice includes the formation of private equity funds and the execution of domestic and cross-border acquisition and investment transactions. Our fund formation practice includes the representation of private equity fund sponsors in organizing a wide variety of private equity funds, including buyout, venture capital, distressed debt and real estate opportunity funds, and the representation of large institutional investors making investments in those funds. Our transaction execution practice includes the representation of private equity fund sponsors and their portfolio companies in a broad range of transactions, including leveraged buyouts, merger and acquisition transactions, strategic investments, recapitalizations, minority equity investments, distressed investments, venture capital investments and restructurings.

Editors:

Doug Warner (*founding editor*)	doug.warner@weil.com	+ 1 212 310 8751
Michael Weisser	michael.weisser@weil.com	+ 1 212 310 8249

If you have questions concerning the contents of this issue, or would like more information about Weil's Private Equity practice, please speak to your regular contact at Weil, or to the editors, practice group leaders or contributing authors:

Contributing Authors:

Christian Bartholomew (DC)	christian.bartholomew@weil.com	+ 1 202 682 7070
Jill Baisinger (DC)	jill.baisinger@weil.com	+ 1 202 682 7033