

Private Equity Alert

SEC Enforcement Staff Focusing on PE Sponsors

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The Division of Enforcement of the SEC has recently made clear that it intends to focus on examining how private equity sponsors do business, including how sponsors value assets and communicate such information to investors. The SEC's Enforcement staff recently sent a 16-page "informal inquiry" letter to certain sponsors inquiring about such issues. The letter requests information related to 12 areas, including fund raising and fund formation, "support for valuations of the fund assets," "documents setting forth a value for any assets owned by the fund" for the prior three years, and details on "all agreements" between the sponsor's funds and those valuing the fund's assets.

Although the Enforcement letter indicates that it should not be construed as an indication that the SEC is investigating firms for securities violations, the letter and recent statements by senior SEC officials make it clear that the SEC is engaged in an industry review to uncover potential violations in private equity. Robert Kaplan, co-head of the SEC Division of Enforcement Asset Management Unit, recently elaborated that the agency is focusing on:

- representations to investors about how portfolio companies are valued;
- promises about future returns when forming funds, such as claiming credit for returns that belong to predecessor firms or making promises based on historical returns that are not realistic today;
- unfair payouts to investors from break-up fees, in particular disproportionate allocation of break-up fees among funds investing side-by-side;
- breaches of fiduciary duty by general partners who operate so-called "zombie funds";
- excessive fees;
- improperly accounting for fees and expenses; and
- insider trading or giving owners or family members improper access to buying shares of a company once the firm has inside knowledge.

According to Kaplan, the SEC plans to increase the number of actions involving private equity sponsors. He remarked that "private equity law enforcement today is where hedge fund law enforcement was five or six years ago," adding that the SEC has brought approximately 50 cases against hedge fund managers in the last 12 months.

We stress that recent changes in the Enforcement Division have substantially increased its ability to effectively pursue such cases. In 2010, the SEC Enforcement Division created the Asset Management Unit to focus exclusively on private equity funds, hedge funds and mutual

Weil News

- Weil advised Oak Hill Capital in connection with the \$4.2 billion sale of its portfolio company, RSC Holdings, to United Rentals, Inc. in a cash-and-stock transaction
- Weil advised Canada's Public Sector Pension Investment Board in connection with its participation in a consortium of investors effecting the \$6.3 billion take private of Kinetic Concepts, a US-based medical devices company
- Weil advised Thomas H Lee Partners in connection with its \$2.2 billion acquisition of Acosta, Inc., a leading full-services sales and marketing agency in the consumer packaged goods industry
- Weil advised Berkshire Partners and OMERS Private Equity in connection with their \$2.1 billion of Husky International, a Canada-based manufacturer of injection molding machines, molds and integrated systems
- Weil advised Mubadala Development Company in connection with its participation in the \$2.2 billion acquisition of EMI Music Publishing by a consortium which also included Sony Corporation and Blackstone Group
- Weil advised Providence Equity in connection with its \$1.8 billion take private of Blackboard, a developer and licensor of e-learning, transaction processing, e-commerce and online community software applications and related services

funds. Kaplan was appointed co-head together with Bruce Karpati, and they have now increased the unit to a staff of 65. In an effort to gain substantive expertise, they have hired several industry experts, including a former manager of private equity funds for Crédit Agricole, as well as a former hedge fund portfolio manager, a former wirehouse trading-desk manager and a former compliance official at a fund of funds.

Moreover, the head of the Enforcement Division, Robert Khuzami, recently announced that the Asset Management Unit is using "proprietary risk analytics to evaluate hedge fund returns. Performance that appears inconsistent with a fund's investment strategy or other benchmarks forms a basis for further scrutiny." Khuzami added that the agency is "using risk analytics and unconventional methods to help achieve the holy grail of securities law enforcement — earlier detection and prevention." Kaplan has made clear that the Asset Management Unit will use these analytical tools in connection with the new focus on private equity sponsors, and has previously said that extraordinary, "outlier" returns are "in most cases, too good to be true" or a sign that "something else was amiss." Finally, provisions of the Dodd-Frank Act requiring private equity sponsors to disclose more information about their investments and outside investors, which come into effect later this year, will provide the SEC with still more leads for enforcement cases.

In light of these important

developments, we recommend that sponsors review their policies, procedures and practice regarding all of the issues raised in this Alert. Even sponsors that have not received the SEC's letter should do so, since it is likely that the SEC will continue to pursue these issues throughout the PE sector.

Weil News (cont)

- Weil advised Ontario Teachers' Pension Plan in connection with its participation in the \$1.3 billion going private acquisition of Blue Coat Systems by a consortium led by Thoma Bravo
- Weil advised Advent International in connection with its €1.15 billion acquisition of the Card Systems and Identity divisions France based Oberthur Technologies

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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.

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