Private Equity Alert

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Recent SEC Developments Impacting Private Fund Sponsors

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OCIE Risk Alert on Frequent Advertising Rule Compliance Issues

The SEC's Office of Compliance Inspections and Examinations (OCIE) recently issued a Risk Alert that provided a list of compliance topics related to the Advertising Rule[1] that OCIE has frequently identified in deficiency letters sent to SEC-registered investment advisers.[2] OCIE identified the following common deficiencies:

- Misleading Performance Results: (1) presentation of performance results without deducting advisory fees and other expenses; (2) comparing results to a benchmark without including disclosures about the limitations inherent in such comparisons; and (3) presentation of hypothetical or "backtested" results without an explanation of how the results were derived.
- Misleading One-on-One Presentations: (1) advertising performance results gross of fees in certain one-on-one presentations, but not including potentially relevant disclosures; and (2) one-on-one presentations that did not disclose that the advertised performance results did not reflect the deduction of advisory fees and that client returns would be reduced by such fees and other expenses, as required by SEC no-action letters.
- Misleading Claim of Compliance with Voluntary Performance Standards: claims that advertised performance results complied with a certain voluntary performance standard (*e.g.*, the Global Investment Performance Standards) when it was not clear that the performance results actually adhered to the performance standard's guidelines.
- Cherry-Picked Profitable Recommendations: (1) including only profitable recommendations in advertisements; (2) advertisements that included the best performing holdings but did not simultaneously include an equal number of the worst performing holdings; (3) advertising specific recommendations without disclosing that the specific recommendations did not represent all securities purchased, sold, or recommended to clients during that period; and (4) discussing in advertisements the profits realized by specific recommendations.
- Failure to Have Compliance Policies and Procedures: (1) to review and approve advertising materials prior to their publication or dissemination; (2) when using composites, to determine the parameters for which accounts were included or excluded from performance calculations; and (3) to confirm the accuracy of performance results.
- Misleading Use of Third-Party Rankings or Awards: (1) advertising awards or accolades that have been obtained by submitting potentially false or misleading information in the applications for such awards or accolades; (2) publishing marketing materials that referenced stale ranking or evaluation information; and (3) publishing potentially misleading advertisements that did not disclose the relevant selection criteria for

[1] The Advertising Rule, Rule 206(4)-1 under the Investment Advisers Act of 1940, generally prohibits registered investment advisers from publishing, circulating or distributing any advertisement that contains any untrue statement of material fact or that is otherwise false or misleading. While the Advertising Rule does not technically apply to Exempt Reporting Advisers, we would urge such advisers to comply with its principles as a best practice.

[2] The full publication is available at: https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf

the awards or rankings (or who created and conducted the survey) and the fact that the adviser paid a fee to participate in or distribute the results of the survey.

- Misleading Use of Professional Designations: references to professional designations that have lapsed or that did not explain the minimum qualifications required to attain such designations.
- Inappropriate Use of Testimonials: client endorsements used in advertisements in violation of the Advertising Rule.

We are aware that in certain circumstances market practice among private fund advisers may deviate from SEC guidance in connection with the Advertising Rule. In light of this Risk Alert, sponsors should review their marketing materials to ensure compliance with the Advertising Rule.

Recent Speech by SEC Regional Director on Continuity and Enforcement Priorities

It was reported that earlier this month, Jina Choi, Director of the SEC's San Francisco Regional Office, spoke at an industry conference and discussed a number of issues relevant to private fund sponsors. Ms. Choi mentioned the continuity at the SEC in the wake of the new administration in Washington, noting that the day-to-day activities of the SEC had changed very little. Ms. Choi remarked that the private equity industry and investment advisers to private funds remain an important priority of the SEC's national exam program and that the SEC's recent focus on private funds was unlikely to subside. Ms. Choi specifically addressed both co-investment practices and credit facilities secured by investors' capital commitments as areas to which the SEC continues to devote enforcement resources. Ms. Choi noted the SEC's concern that co-investment opportunities can favor particular groups of private fund investors in ways that create inherent conflicts. With respect to credit facilities, Ms. Choi remarked that, although such facilities can be used for short-term loans and other liquidity-related concerns, using such facilities with the aim of increasing the internal rate of return or other performance metrics of a fund would be problematic.

SEC Settlement with Private Fund Manager for Misallocation of Broken-Deal Expenses

The SEC recently announced a settlement of approximately $3.5 million with a private equity fund sponsor charged with misallocating certain broken-deal expenses to its private equity funds that should have instead been allocated to co-investors.[3]

According to the settlement order, the Limited Partnership Agreements (the LPAs) of the funds managed by the sponsor expressly permitted the sponsor to allocate all fund expenses, including broken-deal expenses, to the funds. Similarly, the private placement memoranda (the PPMs) disclosed that each fund would "pay all expenses related to its *own operations*…, including… [b]roken [d]eal [e]xpenses." (Emphasis added by the SEC.) The LPAs reserved a percentage of each consummated portfolio investment for co-investors, which included affiliates of the sponsor, and the sponsor used separate co-investment vehicles for each transaction (as opposed to a standing co-investment fund). The LPAs and PPMs did not disclose that the sponsor would allocate broken-deal expenses to the funds for the portion of each investment that would have been allocated to co-investors. The SEC alleged that the sponsor allocated all broken-deal expenses to the funds, including approximately $1.8 million that the SEC determined should have been allocated to co-investors. The SEC also alleged that the sponsor did not adopt and implement a written compliance policy or procedure governing its broken-deal expense allocation practices. The settlement order requires the sponsor to disgorge the misallocated expenses plus interest and pay a civil money penalty of $1.5 million.

Consistent with prior enforcement actions, this settlement is yet another indication that the SEC is intensely focused on the allocation of fees and expenses in the private equity industry. If sponsors have not already done so, they should review their policies to ensure that all fees and expenses, including broken-deal expenses, are allocated in a fair manner between funds and any co-investors, and that such allocation policies are clearly disclosed to all investors.

[3] The settlement order is available at: https://www.sec.gov/litigation/admin/2017/ia-4772.pdf

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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.

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

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