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CLIENT MEMORANDUM

Recent SEC Speech Highlights Concerns and Observations Raised By SEC Exams of Private Equity Fund Advisers

May 8, 2014

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A speech by Andrew J. Bowden, Director of the Office of Compliance Inspections and Examinations (the "OCIE")[1], highlights the Securities and Exchange Commission's ("SEC") continued focus on private equity.

Background

In the aftermath of the Dodd-Frank Wall Street Reform and Consumer Protection Act many advisers to private equity funds have registered with the SEC. Such registration triggered significant additional obligations for advisers to private investment funds, including being subject to SEC review exams. Speeches by SEC staff members have also indicated that the SEC would focus more on advisers to private equity funds and the SEC Division of Enforcement has followed through on this indication by bringing enforcement actions against certain private equity advisers.[2]

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1 SEC Speech, "Spreading Sunshine in Private Equity" *available here.*

2 *See* Willkie Farr & Gallagher Client Memorandum "Two Recent SEC Enforcement Actions Highlight the SEC's Focus on Private Equity Fund Managers" *available here*; *SEC v. Lawrence E. Penn, III, Michael St. Altura Ewers, Camelot Acquisitions Secondary Opportunities Management, LLC, the Camelot Group International, LLC and Ssecurion LLC,* (Jan. 30, 3014), press release and complaint *available here,* and *In the Matter of Brian Williamson*, File No. 3-15430 (Jan. 22, 2014), *available here*.

Discussion

Addressing the Private Equity International, Private Fund Compliance Forum 2014 held in New York, Mr. Bowden described the approach taken by the OCIE when reviewing compliance programs of private equity funds advisers.

He indicated that the following factors and trends play a significant role in OCIE's concerns:

- *Private Companies*. Private equity funds invest in, and in many cases control, private companies that are not subject to disclosure rules applicable to public companies and as a result have potential conflicts of interests that other investment advisers may not face. For example, where private equity fund advisers instruct a portfolio company to (i) retain certain consultants that are affiliated, or otherwise have a preferred relationship, with the adviser to provide certain services, (ii) reimburse the adviser for, or pay directly, certain expenses incurred in connection with monitoring the investment or (iii) retain certain of the adviser's employees to work for the portfolio company.

- *Partnership Agreements*. The governing documents of private equity funds often lack defined parameters and contain broad and sometimes imprecise language with respect to the type of information required to be provided to investors regarding the underlying investments, the types of expenses and fees that can be charged to or that are payable by portfolio companies, valuation procedures and protocols for resolution of potential conflicts of interest.

- *Consolidation*. Consolidation has created significant opportunities for advisers to rapidly grow their AUM often through creating side by side co-investment funds and managed accounts. With this rapid growth there are concerns that the adviser's compliance functions have not grown sufficiently enough to handle complex issues such as allocation of broken deal expenses, or other costs, amongst the various pools of available capital.

Mr. Bowden also shared some observations resulting from the several exams conducted by the OCIE. In particular, he discussed the following common issues found in recent exams:

- *Operating Partners*. Noting when they have reviewed how fees and expenses are collected and allocated by private equity fund advisers they have identified what they believe are either violations of law, or material weaknesses in controls, over 50% of the time, Mr. Bowden specifically highlighted that "operating partners," who generally provide consulting services to portfolio companies, may raise particular concerns. Although these "operating partners" often work exclusively for a manager and are described as members of the investment team, Mr. Bowden expressed concern that in many instances they are not paid by the adviser but receive fees from portfolio companies and, in many of these instances, he believes that investors are not aware that these "operating partners" receive these fees (which are typically not offset against management fees).

- *Hidden Fees and Expenses*. Mr. Bowden pointed out concerns regarding, what he described as, "hidden fees" that could result from, as an example, accelerating payment of monitoring fees in connection with an exit transaction or charging administrative fees or transaction fees in connection with recapitalizations when such fees are not contemplated by, or are in excess of the amounts contained in, the relevant governing documents. Mr. Bowden also indicated that they have observed a trend of advisers shifting expenses (e.g., compliance, legal and accounting) from themselves to the funds — without disclosure to the limited partners.

- *Marketing and Valuations*. The most common issue presented to the OCIE when reviewing marketing materials concerned portfolio valuations, including whether the actual valuation process aligns with the valuation process described in the offering documents. Items being scrutinized with increased attention include cherry-picking comparables, questionable add backs to EBTIDA calculations, changing valuation methodologies from period to period (especially when approaching fundraising), misstatements about levels of involvement (including failure to reflect resignations) of members of the investment team and use of projections as opposed to actual valuations when presenting performance history.

Conclusions

Mr. Bowden's speech is another recent and strong reminder of the increased attention and review by the SEC of private equity fund advisers. It calls for registered advisers of private equity funds to continue to enhance their compliance programs and take steps to ensure a strong compliance culture within their firms.

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