Investment Management
and Private Equity Practices

To: Our Clients and Friends

May 14, 2014

Spreading the Sunshine in Private Equity: SEC's Observations from OCIE's Presence Exams of Private Equity Fund Advisers

Last week Drew Bowden, Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE") shared initial results of their private fund presence exams that have been on-going since October 2012. These findings provide guidance for private fund adviser operations and fund document disclosures.

In his speech at the PEI Private Fund Compliance Forum, Mr. Bowden announced that the SEC identified violations of law or material weaknesses in controls in over 50% of the 150 newly registered private equity fund advisers examined. Mr. Bowden highlighted the following key areas of focus:

Limited Partnership Agreements:

The SEC views limited partnership agreements as lacking in several key areas. Mr. Bowden stated that many agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies as opposed to being charged to the fund's adviser. Without detailed disclosure, advisers may be charging fees and passing along expenses to the fund or portfolio companies that are not reasonably contemplated by limited partners. The SEC also raised concerns about the lack of clearly defined valuation procedures, investment strategies and protocols for mitigating certain conflicts of interest, including investment and co-investment allocations, and insufficient information rights that prevent limited partners from monitoring an adviser's investments and operations.

Growth of Separate Accounts and Side-By-Side Co-Investments:

The SEC observed that much of the growth in the industry is coming from separate accounts and co-investments that invest alongside funds instead of more traditional single commingled funds. Mr. Bowden noted that broken deal expenses or other costs associated with generating deal flow are allocated to funds but often are not also allocated to separate accounts and co-investment vehicles.

Operating Partners:

One the most common deficiencies the SEC found in the area of fees and expenses involved the use of an adviser's consultants, or operating partners, who provide consulting or other services to portfolio companies. Operating partners are not typically employees of the adviser, but are hired and paid for by portfolio companies. When operating partners are presented as part of an adviser's team, limited partners may not realize that operating partners' compensation is not included in, and will not offset, the adviser's management fee.

Expense Shifting:

The SEC found advisers shifting expenses from themselves to the fund or portfolio companies without sufficient disclosure. In certain instances, advisers were found to bill funds for various back-office functions (limited partner reporting, compliance, legal and accounting) that were traditionally included as a service provided in exchange for a management fee. Other funds presented individuals as employees of the adviser during the fundraising stage, terminated them and hired them back as "consultants" to be paid for by the funds or portfolio companies.

Hidden Fees:

Another common deficiency found during these exams included hidden fees that are not adequately disclosed to limited partners. Monitoring fees are commonly charged to portfolio companies by advisers in exchange for board and other advisory services during a portfolio company's holding period. The SEC found some of the monitoring agreements had a longer duration than the fund's term, self-renewed annually or had an indefinite term. When these agreements terminate, whether in the event of a merger, acquisition, IPO or otherwise, the adviser may collect a fee to terminate the agreement which also may include an acceleration of all monitoring fees due for the duration of the contract. The SEC also found other undisclosed "administrative" or other fees not contemplated by the limited partnership agreement, exceeding limits for transaction fees or charging transaction fees not contemplated by the limited partnership agreement in certain instances, such as recapitalizations.

Marketing and Valuation:

A common valuation issue that the SEC noted was advisers using a valuation methodology different than the one disclosed to investors. Mr. Bowden emphasized that their intent is not to second-guess an adviser's assessment of the value of the fund's portfolio company. Rather the SEC is focused on cherry-picking comparable companies or changing methodology from period to period without additional disclosure, even if such actions are within a broadly defined valuation policy.

Examiners are also reviewing marketing materials to look for other inconsistencies and misrepresentations, including a focus on performance marketing, use of projections and misstatements about the investment team particularly where a key team member resigns or announces a reduced role soon after a fund-raising is completed.

The SEC is continuing to develop expertise in this area, including forming a special unit of examiners who will focus on leading examinations of advisers to private funds. Advisers should consider the following actions:

- Review fund documents, other disclosures, policies and procedures against current practices to ensure consistency with current practices. Are the costs of operating partners adequately disclosed? Do your valuation policies and procedures align with current practice?
- Review limited partnership agreements to determine if additional disclosure is necessary for an investor to anticipate which fees and expenses will be incurred by the adviser, its affiliates, the fund and portfolio companies. Does the disclosure in more recent funds provide additional clarity than in prior funds?
- If using separate accounts or co-investment vehicles, determine expense allocation methodology and update policies and procedures if necessary.

Please click here for text of Mr. Bowden's full speech.

For questions or further information, please reach out to your regular Bryan Cave contact or the authors of this alert:

Elizabeth Kemery Sipes
(303) 866-0348
elizabeth.sipes@bryancave.com

Mark W. Weakley
(303) 417-8549
mark.weakley@bryancave.com

John P. Goebel
(312) 602-5155
jpgoebel@bryancave.com