Compliance Update for SEC-Registered Private Equity Fund Advisers

On May 6, 2014, Andrew Bowden, the Director of the Office of Compliance Inspections and Examinations (OCIE) at the Securities & Exchange Commission (SEC) made a helpful presentation regarding the concerns the SEC has found in its examinations of SEC-registered private equity (PE) advisers as well as their areas of focus in examinations.

OCIE Overview:

- OCIE consists of 900 examiners that are responsible for conducting examinations of more than 25,000 SEC registrants, including approximately 11,000 registered investment advisers.
- 10% of the 11,000 registered advisers provide services to at least one private equity fund.
- OCIE has formed a special unit of examiners within this group that will focus on leading examinations of advisers to private funds.

Presence Examination Initiative:

- This initiative commenced in October 2012 and is nearly complete. The goal was to quickly establish a presence with the PE industry and assess issues and risks presented by its unique business model.
- OCIE has examined more than 150 newly registered PE advisers and are on track to examine 25% of new private fund registrants by the end of 2014.

Risks Presented by Private Equity (As Seen by the SEC)

- Unlike a typical buy-side adviser, PE advisers typically use client funds to obtain a controlling interest in a non-publicly traded company.
- This setup presents risks due to the control and paucity of disclosure required by privately held companies, and temptations and conflicts are presented that are not present in other models.
- Some of these include:
  - The PE Adviser can instruct a portfolio company it controls to hire the adviser, an affiliate, or a preferred 3rd party to provide certain services.
  - This PE Adviser can set the terms of the engagement of this structure, including the price to be paid for the services.
  - The PE Adviser can instruct the portfolio company to pay the adviser's bills or to reimburse the adviser for certain expenses in managing its investment in the company, or instruct the company to add to its payroll all of the adviser's employees who manage the investment.

General Areas of SEC Focus & Concern:

- **Limited Partnership Agreements:** The SEC believes that often PE Limited Partnership Agreements lack investor protection in the following areas:
  - <u>Fees & Expenses:</u> Many LPAs are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being

borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses not reasonably contemplated by investors. Poor disclosure in this area is a frequent source of PE exam problems with the SEC.

  - Information Rights: Many LPAs do not provide limited partners (LPs) with sufficient information rights to be able to adequately monitor their investments, as well as the operations of their manager. This creates opaqueness and transparency concerns.
  - Other Areas of Concern in LPAs: SEC has seen LPAs lacking clearly defined valuation procedures, investment strategies and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.

- **Accepted Lack of Transparency**
  - The SEC is concerned about the lack of transparency and limited investor rights in private equity and the fact that while many investors conduct due diligence before investing in a fund, they believe investor oversight is much more lax after closing.
- **General Industry Trends Pressuring PE Advisers**
  - The SEC believes that industry trends, such as consolidation and shake out in the industry, are generating pressure on PE firms and heightening the risk of a misalignment of interests between advisers and investors.
  - These relevant trends include:
    - Zombie Advisers: The SEC continues to see zombie advisers, or managers that are unable to raise additional funds and continue to manage legacy funds beyond their expected life. The managers are incentivized to profit from their current portfolio and may increase their monitoring fees, shift more expenses to their funds or push the envelope in marketing by increasing interim valuations, often inappropriately and without proper disclosure.
    - Larger Manager Issues: Due to consolidation, advisers that are rapidly able to grow their assets under management have grown larger and have added different product lines, stake holders and products and some of these have had difficulty adjusting to the complexities and inherent conflicts of interest in their new business model.
      - Increased Governance/Compliance Issues: OCIE's experience is that complexity and rapid growth have created governance and compliance issues at larger managers. Much of the growth in PE is coming from separate accounts and side-by-side co-investments.
      - Problems with separate accounts/side-by-side co-investments: OCIE believes much of the growth has occurred in these types of investments and that these accounts are often not allocated broken deal expenses or other costs associated with generating deal flow. They believe this may be occurring because the adviser has failed to update its policies and procedures to handle separate accounts or because the adviser has not invested sufficient capital in their compliance function and back-office to perform a proper allocation.
    - PE Returns Compressing/Converging: OCIE believes that due to this effect, fewer managers will be able to overcome their preferred return and collect carried interest, heightening risk that managers will make up that shortfall by

collecting additional fees or shifting expenses to their funds. ***OCIE believes this has been a significant issue that has been seen in their oversight of PE registrants.***

SEC Examination Focus & Observations

EXPENSES

- Expenses are a primary focus of OCIE in their exams, particularly the collection of fees and the allocation of expenses.
- ***In OCIE's examinations of PE funds, they have identified what they believe are violations of law or material weaknesses in controls in over 50% of the exams.***
    - Historically, the most frequently cited deficiencies in adviser exams involve:
        - (1) inadequate policies & procedures; or
        - (2) inadequate disclosure
    - The deficiency rate for these two most commonly cited deficiencies usually runs between 40-60% of all adviser examinations conducted annually. As a result, with 50% of PE advisers being cited for this issue relating to fees & expenses, this is significant.
- Common Deficiencies in Fees & Expenses Include:
    - **Operating Partners/Consultants:** Operating Partners or consultants have been brought into portfolio companies as an effort for funds to generate value through operational improvements. While this model is effective, it has resulted in concerns about how these individuals are compensated:
        - **"Back Door Fees":** Many Operating Partners are paid directly by portfolio companies or the fund without sufficient disclosure to investors. This creates an additional "back door" fee that many investors do not expect, since these individuals are held out by the adviser as their employees and often have titles at the adviser, work exclusively for the adviser and have offices at the adviser. Further, these individuals appear as full members of the team on the website of the adviser and in marketing materials. ***Unlike other employees however, they are expensed to the fund or the portfolio companies, and are not paid by the adviser.***
            - There are 2 problems with this compensation arrangement:
                - (1) Investors do not realize they are paying these individuals *a la carte* in addition to the management fee and carried interest. While the manager benefits from marketing these individuals, it is the investor footing the bill for these resources.
                - (2) Most LP agreements require that a fee generated by employees or affiliates of the adviser offset the management fee, in whole or in part. However, as Operating Partners are not usually treated as employees or affiliates of the adviser, the fees they received rarely offset management fees.

- **Expense Shifting from Adviser to Client/Fund:** There appears to be a trend of advisers shifting expenses from themselves to their clients during the middle of a fund's life, without disclosure to the limited partners. Some examples include:
    - <u>Rehiring as Consultants</u>: Individuals presented to investors as employees of the adviser during fundraising, who are terminated, then rehired as consultants by the funds or portfolio companies, with these being their only clients.
    - <u>Billing Funds separately for back-office functions</u>: Advisers have billed their funds separately for various back-office functions that have traditionally been included as a service provided in exchange for the management fee, including compliance, legal and accounting – without proper disclosure of these shifting costs.
- **Use of Automation to Shift Expenses:** Advisers have commonly been using process automation to shift expenses. For example, it is now becoming common to automate the investor reporting function, rather than having adviser employees compile portfolio company information and distribute reports. <u>While this is not a concern on its face because it makes advisers more efficient, it is a concern when the costs for the software and implementation are borne by the fund and not the adviser</u>, this may be contrary to reasonable expectations of LPs under their LP agreement.

<u>HIDDEN FEES</u>

- The flipside of expense-shifting is charging hidden fees not adequately disclosed to investors. These fees include:
    - **Accelerated Monitoring Fees**
        - Monitoring fees are charged to portfolio companies by advisers in exchange for the adviser providing board and other advisory services during the portfolio company's holding period.
        - Of particular concern, if not disclosed to limited partners, are that some advisers have caused their portfolio companies to sign monitoring agreements that obligate them to pay monitoring fees for 10 years or longer, many of which significantly beyond the life of the Fund.
            - Mergers, Acquisitions and IPOs trigger these agreements as an adviser will collect a fee to terminate the monitoring agreement, which the portfolio company was originally forced to sign. <u>This termination usually takes the form of the acceleration of all the monitoring fees due under the duration of the contract, discounted at the risk-free rate, resulting in extremely high fees.</u> This is often not disclosed at the time the monitoring agreements are signed.
    - **Undisclosed "Administrative" or other fees not included in the LPA;**
    - **Exceeding transaction fee limits in the LPA;**
    - **Charging Transaction Fees in cases not contemplated in the LPA, such as recapitalizations;**
    - **Hiring related-party service providers that deliver services of questionable value.**

MARKETING & VALUATION

- The SEC sees marketing as a key risk area as the PE fund-raising market continues to be tight for some advisers. Some practices are of particular concern to OCIE.
    - **Valuation:** Valuation is a clear signal to investors about the health of an adviser's most current portfolio and may be the most relevant thing to an investor.
    - **Note: SEC examiners don't second-guess the assessment of the value of the portfolio companies that are owned by funds when looking at valuation, they are looking at whether the actual valuation process aligns with the process that an adviser has promised to investors.**
        - Some of the valuation issues focused on by the SEC include:
            - Ensuring The Valuation Methodology Being Used Is The Same As the One Promised to Investors
            - Ensuring that Advisers aren't Cherry-picking comparables or adding back inappropriate items to EBITDA, especially costs that are recurring or persist after a strategic sale.
                - Ensuring there are rational reasons for the changes to these and/or determining if there are sufficient disclosures to alert investors.
            - Changing the Valuation methodology from period to period without additional disclosure, even if these actions fit into a broadly defined valuation policy, unless there is a logical purpose for the change.
                - Example: Examiners have observed advisers changing from using trailing comparables to using forward comparables, which resulted in higher interim values for certain struggling investments.
    - **Marketing:** Examiners are reviewing marketing materials to look for other inconsistencies and misrepresentations. Some areas of particular focus include:
        - **Performance Marketing:** Where projections might be used in place of actual valuations without proper disclosure.
        - **Misstatements About the Investment Team:** Situations where key team members resign or announce a reduced role soon after fund-raising is complete, raising suspicions that an adviser knew these changes were forthcoming but did not communicate them to potential investors before closing.

Contact:

If you have any questions or concerns about this PE Compliance Update, please contact Chris Hayes, SBIA's Legislative & Regulatory Counsel at (202) 628-5055 or chayes@sbia.org