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Client Alert

Private Equity and Investment Management Practice Group

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Three Disclosure Areas of Focus for Private Equity Firms Given Increased SEC Oversight

The private equity space is an area of increased scrutiny for the SEC. The SEC's Office of Compliance Inspections and Examinations (OCIE) earlier this year announced its intentions to examine a significant percentage of never been examined investment advisers, and prior to that OCIE announced its plan by the end of 2014 to examine 25% of private fund advisers who registered as a result of Dodd Frank. The OCIE Staff has geared up for these reviews and examinations by hiring private equity experts with significant experience in the industry.

Preliminary SEC Findings

Preliminary information regarding results of these examination initiatives has been made public in recent weeks and reflects a focus on transparency and disclosure-related issues. The preliminary results of the initiatives, taken together with public comments by the Staff of the SEC Enforcement Division's Asset Management Unit, warrant your attention to be prepared for your next examination or discussion with the Staff. Below are three key areas of disclosure where you should consider increased levels of review.

Fees and Expenses

The Staff has cited as a frequent exam finding (in 50% of exams) limited partnership agreements and disclosure documents that are lacking in their characterization of the types of fees and expenses that can be charged to portfolio companies as well as practices relating to fees and expenses, which in the Staff's view "highlight material weaknesses in controls and in some instances violations of law." The Staff cites instances from its exams in which it found expenses to shift without disclosure from the investment adviser to its clients in the middle of a fund's life. For example, the adviser's overhead related expenses generally are paid from management fees – a shift to treating some portion of these expenses as fund-level expenses without disclosure would be cause for concern. The fee and expense provisions of the fund's disclosure documents should be clear in laying out the agreed upon fund borne fees so that managers can implement those provisions on a basis consistent with the disclosure.

Another fee-related area where disclosure was frequently found to be deficient related to use of consultants or "Operating Partners." Operating Partners refer to individuals or organizations that provide some specialized experience or services in connection with portfolio companies. Payments

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made directly to consultants or Operating Partners by the fund or its related investment vehicles may need to be disclosed to investors, in particular, if some portion of the fees payable to the consultant or the partner are rebated to or otherwise economically shared with the manager. The economic sharing of fees with consultants and Operating Partners may be not only in the form of direct rebates to the manager, but also could be deemed to include indirect benefits attributable to group buying programs in which commissions are remitted to the manager, economic interests in the Operating Partner or consultant, discounted pricing benefiting the manager or other similar indirect benefits that may not be addressed in disclosure. Consultant engagements and, in particular affiliations with the manager, are factors likely to cause a closer look from the Staff as to the transparency of these arrangements. In light of this likely increased scrutiny, managers should concentrate on these arrangements in connection with their disclosure review.

Performance Marketing

The Staff has long focused on misleading or inadequate disclosures regarding historical and projected performance information. In its most recent discussion of the topic, the Staff indicated its renewed focus on performance marketing and the use of projections rather than actual valuations without proper disclosure. As an initial matter, historical performance information should be presented for realized investments on a basis that does not "cherry-pick" the best return examples—showing individual asset or investment returns without aggregate returns for an entire portfolio will raise red flags with the Staff. In preparing disclosure regarding currently held assets, managers should carefully review and consider not only the actual results from the valuation analysis, but the disclosure that accompanies the performance information. For example, anticipated returns and other performance information for currently held assets should be clearly identified, together with the methodology used in calculating information. The description of the methodology should describe the material assumptions and sensitivities underlying the analysis so that investors may make independent determinations on the basis for the information.

Valuation

The Staff has indicated that they view lack of transparency into the valuation of illiquid assets and the operations of portfolio companies to be prevalent among private equity products, and the Staff has cited limited partnership agreements and other disclosure documents as missing clearly defined valuation procedures. The Staff has seen instances where an adviser may change valuation methodologies period-to-period within a broadly defined valuation policy. This ability to make interim changes to valuation methodologies will be a red flag for examiners, and difficult to support for investment advisers without more fulsome disclosure to investors. The Staff has found a related issue to be common practice, and potentially of greater concern; namely, the use by an adviser of a valuation methodology which is different from the one that has been disclosed. OCIE examiners will scrutinize whether the actual valuation process aligns with the process that an adviser has outlined for investors.

Conclusion

The SEC is engaged in a broad-reaching audit of private equity firms and, as part of this process, has hired industry specialists. These new personnel understand complex transactions and can gauge whether disclosure is fulsome. Consult with experienced counsel if you have any uncertainty as to whether your disclosure is appropriately drafted in light of your practices, your particular funds and investors and given the SEC's focus on this area.

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