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SEC's Findings and Observations on OCIE's Presence Exam Initiative

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During his speech on May 6, 2014, Andrew J. Bowden, the Director of the Office of Compliance, Inspections, and Examinations (OCIE) of the Securities and Exchange Commission (SEC) provided an overview and initial observations from OCIE's Presence Exam Initiative (Initiative), which was launched in October 2012 to engage and interact with the private equity industry. The main goal of the Initiative is to quickly establish a presence within the private equity industry and to better assess the unique issues surrounding the private equity business model. Mr. Bowden outlined a number of trends arising within the private equity industry and recounted the SEC's initial observations after its examination of over 150 registered private equity advisers.

At the outset, Mr. Bowden addressed a few trends that the SEC has observed during the course of the Initiative, including: (1) issues with "zombie" advisers, *i.e.*, managers that continue to manage legacy funds past their expected life without additional funds; (2) governance and compliance issues in the wake of rapid industry growth; and (3) compressing and converging returns, which may result in attempts to cover the shortfall in revenue by assessing additional fees or shifting expenses to the fund.

Mr. Bowden emphasized that limited partners should closely examine their limited partnership agreements. The industry considers limited partnership agreements as sources of investor protection. The SEC, though, has found that many of these agreements fail to provide proper investor protection. Some of the shortfalls include: (1) failing to identify and characterize fees and expenses that can be, and usually are, passed on to limited partners; (2) failing to clearly identify valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interests; and (3) failing to provide limited partners with the ability to adequately monitor their investments. From the SEC's perspective, without proper disclosure and review, the alleged protective measures built into limited partnership agreements could, and often do, amount to significant exposure to unforeseen liability.

Mr. Bowden then shifted focus to discuss three main issues that OCIE specifically identified through the course of its examinations: (1) expenses; (2) hidden fees; and (3) marketing and valuation issues. Mr. Bowden's commentary made clear that the SEC is taking a harder look and scrutinizing private equity funds to ferret out lax governance and compliance relating to these issues.

I. Expenses

Mr. Bowden stated that, in the SEC's view, over 50% of examined advisers either violated the law or displayed material weaknesses in controls with respect to *how* the fund advisers handled fees and expenses. For example, the most common deficiency is a firm's use of "Operating Partners" who are not employees of the advisers; rather, they are hired to advise the fund. Many of these Operating Partners, however, are paid directly by portfolio companies or by the funds without sufficient disclosure to investors, effectively creating an additional, yet unexpected, fee.

Another example of an expense-related issue is shifting expenses. Trends are emerging of advisers shifting expenses to the limited partners during the middle of a fund's life without proper disclosure to the limited partners. The two most common examples are terminating advisers and hiring them back as consultants and advisers billing funds separately for back-office functions without proper disclosure (*e.g.*, compliance, legal, and accounting services). Again, without proper disclosure of these issues, limited partners can be subject to large unforeseen fees.

II. Hidden Fees

In addition, there is a growing issue of hidden fees, such as the accelerated monitoring fee. Typically, advisers provide portfolio companies with board and other advisory services during the holding period, which usually last around five years. Some advisers, however, knowingly implement monitoring agreements that last ten years or longer—some even running past the term of the fund. Mergers, acquisitions, or IPOs then trigger the acceleration clause in these agreements, allowing the adviser to collect a termination fee. The termination usually takes the form of an acceleration of all the monitoring fees due for the duration of the contract, discounted at the risk-free rate.

Other hidden fees include charging undisclosed "administrative" fees not contemplated by the limited partnership agreement; hiring related-party service providers who deliver services of questionable value; exceeding limits set in the limited partnership agreement for transaction fees; and charging transaction fees in cases not contemplated by the limited partnership agreement.

III. Marketing and Valuation

Finally, Mr. Bowden addressed valuation and marketing issues affecting the private equity industry. Through the course of its examinations, the SEC has found that common valuation issues involve advisers using a methodology different from the one initially disclosed to investors. Because investors and their consultants and attorneys rely upon the valuation methodology that an adviser promises to utilize, the SEC is scrutinizing whether the actual valuation process aligns with the process that an adviser has promised to investors. Mr. Bowden notes, though, that the SEC is not in the business of second guessing valuation methods *per se*, but rather, the act of disclosure and compliance *related* to the methodologies.

The SEC is also reviewing marketing materials for inconsistencies and misrepresentations, with a focus on performance marketing and misstatements about the investment team. Advisers should take care to sufficiently disclose marketing variables that could affect investor decisions.

Based on OCIE's initiatives, and the SEC's increased focus on these issues, private equity advisers should review their existing disclosure and compliance policies to ensure that their practices align with their disclosures.