CLIENT ALERT

SEC OCIE Director's Speech Highlights Heightened Scrutiny of Private Fund Advisers

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In a speech on May 6, 2014, the director of the SEC's Office of Compliance Inspections and Examinations (OCIE) gave valuable insights into the substantive review that the OCIE has been performing on registered private equity fund advisers since implementing the presence exam initiative in October 2012. Perhaps the most striking comment is that more than half of all private equity advisers examined by the OCIE have been found to be violating laws or to have material weaknesses with respect to how they assess fees and expenses.

The speech indicates that the OCIE views private equity advisers as being faced with "temptations and conflicts with which most other advisers do not contend" and that the industry suffers from a lack of transparency that compromises investors' ability to evaluate their investments and their advisers' operations.

As such, the OCIE appears to be taking a robust review of fund sponsors' marketing documents, fund agreements, and protocols with respect to compliance, conflicts, fees, expenses and valuations.

Key points and takeaways:

Vague Limited Partnership Agreements and Hidden Fees

The director's speech clearly indicates that the OCIE expects marketing materials, limited partnership agreements and financial reports to be explicit about fees and expenses. The OCIE specifically has found that limited partnership agreements (LPAs) are often too vague, "creating an enormous grey area allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors."

Therefore, an OCIE examination will scrutinize:

- any fees charged to the fund other than as contemplated in the fund's governing documents;
- the nature of the fees charged and the disclosure of such fees;
- any shift of expenses to investors during the middle of a fund's life;
- arrangements where consulting fees are charged to the fund, especially if those consultants were portrayed as part of the investment team during the diligence process;
- various back-office functions (i.e., compliance, legal, accounting) billed separately by advisers to their funds without proper disclosure;
- hiring related-party service providers who deliver services of questionable value;
- "zombie" funds that continue to manage legacy funds and generating fees for advisers even though they are long past their expected life; and
- so-called "monitoring fees".

Specifically with respect to monitoring fees, which are commonly charged to portfolio companies by advisers in exchange for the adviser providing board and other advisory services during the portfolio company's holding period, the OCIE has been reviewing the terms of such arrangements in light of investor disclosures. The OCIE perceives that investors are often not aware of the terms of such arrangements, in particular the scope of fees and aggressive terms for acceleration upon cancellation, when such cancellation is at the adviser's option.

Marketing and Valuation Concerns

The OCIE views marketing to be a key risk area for private fund advisers, particularly with respect to valuations, track records and the investment team. The OCIE focuses especially on situations where key team members resign or announce a reduced role soon after fundraising is completed.

Another common issue the OCIE has seen is advisers using a valuation methodology different from that disclosed to investors. Two particular areas of concern for OCIE examiners are:

- cherry-picking comparables or adding back inappropriate items to EBITDA; and
- changing the valuation methodology from period to period without additional disclosure. For example, changing from trailing comparables to forward comparables that results in higher interim values, can be problematic, especially if not consistent with the adviser's valuation policy or if not clearly disclosed.

Focus on Robust Internal Compliance

The OCIE wants to see advisers embrace a robust compliance program, and, in the OCIE's view, "it's clear that in many instances [advisers'] compliance functions are not growing as quickly as their businesses." The director stressed the importance of setting the tone of compliance and weaving compliance considerations throughout the fabric of the firm. As mentioned by the director:

> It all starts at the top. A compliance department has the best chance of success if management is fully supportive of compliance efforts and provides the CCO with the resources needed to do an effective and thorough job. Additionally, strength and effectiveness of a compliance department is boosted when compliance officers not only understand relevant laws and rules, but are integrated into a firm's business. In OCIE, we've seen that compliance officers, who – for example – participate in weekly deal meetings and in meetings with investors, or who review deal memos, tend to be more effective in spotting issues early and are more respected in their organizations. As a result, we generally see their firms tending to be more compliant.

Compliance officers should perform a central and valued role. A compliance function that is distant from the decision making process likely will not pass muster. Compliance officers need to be proactive and well-informed about the nature of the business, the relevant laws, the terms of a fund's governing documents, internal policies and protocols for industry practices.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.