Quinn Emanuel Private Equity Litigation Practice Alert
Minimizing Exposure to SEC Examinations and Enforcement Actions

Background

Competition for investors, deals, and returns has led many private equity firms to modify their fee structures, alter their investment criteria and strategies, and expand their platforms. In some cases, this has led to new potential conflicts of interest. We are increasingly seeing situations where a fund's disclosures or governance provisions have not kept up with the fund manager's current practices. Some private equity sponsors have been lulled into a sense of complacency because of the SEC's seeming focus in other areas. This is a mistake. In our view, it's only a matter of time before the SEC begins to scrutinize the private equity industry more closely. Private equity firms can minimize their exposure by ensuring that their disclosures reflect or anticipate new business practices or conflicts of interest that have arisen or that might arise over the life of the fund.

Now is the time for private equity clients to evaluate the adequacy of their disclosures. To avoid protracted SEC examinations and potential enforcement actions, advisers should have their disclosures and operations reviewed by someone with the right skill set sooner rather than later—long before the SEC comes knocking.

Conducting a Self-Assessment with an SEC Lens

When conducting a self-assessment, firms should analyze their disclosures with an enforcement-avoidance mindset. Reviewing a disclosure from the standpoint of a skeptical SEC examiner is key. During an exam or investigation, fund managers often find themselves justifying disclosures from the "what we meant was . . ." or "everyone knew that . . ." perspective. But SEC examiners and investigators have a distinctly retrospective viewpoint that is often at odds with the business realities that go into crafting disclosures at the formation stage. Crisp, clear and direct disclosures eliminate ambiguity and leave no room for an enterprising SEC staffer to claim that a fee, conflict of interest, or valuation methodology was hidden or did not operate as described. Likewise, ambiguities should always be interpreted in a manner that favors investors over advisers.

Disclosure Priorities

We offer below some suggestions to clients for how best to minimize the risk of protracted entanglement with the SEC arising from currently evolving business practices and dated governance terms and disclosures.
Strong written fee disclosures — Private equity managers should examine their expense and fees disclosures with rigorous scrutiny. The SEC views dimly any attempt by fund managers to take fees or expenses that are not explicitly and clearly defined, even if the fund manager believes it was acting in good faith. Moreover, SEC staff take an expansive view of the items that can be considered fees or expenses. For example:

- In September 2019, the SEC entered into a settlement with a private equity firm arising from claims that it improperly collected management fees based on total invested capital contributions from limited partners, contrary to the governing documents for the fund that prohibited the calculation of management fees based on investments that had been written off or written down.[1] Regularly auditing the fund's actual practices against the key provisions of its disclosures can help prevent these types of enforcement actions.

- In May 2019, the SEC entered into a settlement with a private equity manager arising from claims that, contrary to the terms of the fund LPA, the manager improperly misclassified investment placement fees as organizational expenses and charged them to limited partners of the fund.[2] The SEC's Order specifically observed that the private equity manager lacked written policies and procedures to ensure that organizational expenses were properly classified.

Strong written conflict of interest disclosures — Private equity managers face a thicket of potential conflicts stemming from their relationships with portfolio companies. Even standard industry practices can be considered an undisclosed conflict of interest by SEC staff. For example:

- In December 2018, the SEC entered into a settlement with a fund manager arising out of claims that it failed to disclose its arrangements with third-party service consultants that resulted in expense allocation decisions between client funds and non-client purposes that posed actual or potential conflicts of interest.[3]
- In April 2018, the SEC entered into a settlement with a private equity adviser arising from claims that it failed to disclose an arrangement with a third-party service provider.[4] Under the arrangement, the adviser earned compensation derived from fund purchases made through the service provider, i.e., based on fund spending, and the SEC considered this to be a potential conflict. Enforcement actions like these demonstrate that private equity firms should regularly scrutinize their relationships with affiliates and third-party service providers to ensure that the nature of the potential conflict and the compensation arrangements are disclosed and permissible under the relevant fund documents.

Strong written expense allocation disclosures — Equally as important as fee disclosures are disclosures about how fees and expenses will be allocated between funds and between the funds and the manager, and the allocation of expenses for in-house and third party service providers. For example:

- In December 2018, the SEC entered into a settlement with a private equity adviser arising from an alleged failure to allocate broken deal, legal, consulting, insurance and other expenses between client-invested funds and employee co-investment funds, and instead, allocated all of these expenses to the client-invested funds.[5] Even though the organizational documents disclosed that the funds would be allocated expenses, the SEC challenged the practices because the adviser did not disclose that the employee funds would not be allocated a proportional share of such expenses.
- In December 2018, the SEC entered into a settlement with a private equity manager arising from claims that it improperly allocated all compensation-related expenses of its employees that provided fund advisory services to the funds, even though the employees spent some of their time on matters unrelated to providing fund advisory services.[6] The SEC recognized that while the fund disclosures provided notice that the funds would be charged for the expense of providing advisory services, it did not clearly disclose that the funds would be charged all compensation expenses, including for matters unrelated to management of the funds.

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[1] https://www.sec.gov/litigation/admin/2019/ia-5373.pdf
[2] https://www.sec.gov/litigation/admin/2019/ia-5229.pdf
[3] https://www.sec.gov/litigation/admin/2018/ia-5074.pdf
[4] https://www.sec.gov/litigation/admin/2018/ia-4896.pdf
[5] https://www.sec.gov/litigation/admin/2018/ia-5096.pdf
[6] https://www.sec.gov/litigation/admin/2018/ia-5079.pdf

Strong written disclosure of valuation methods and calculation of IRRs —Valuation has long been a priority for the SEC in the private fund context. Valuation often involves some degree of subjectivity and the investments are often illiquid. It thus creates opportunities for second guessing by the SEC. For example:

- In June 2019, the SEC entered into a settlement with a private fund adviser arising from claims that it had improperly valued fund assets.[7] The adviser allowed its portfolio managers to gradually mark-up asset prices rather than mark them to their market value. In particular, the SEC took issue with the adviser's policies and procedures, and specifically the lack of policies to ensure that valuations were conformed with Generally Accepted Accounting Principles. Private equity advisors can protect themselves from SEC scrutiny by relying upon third party valuations whenever possible and by ensuring that the valuation practices are well-documented.

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We frequently help clients evaluate their disclosures in light of current or newly developed practices, with an SEC examiner perspective, to help ensure they are well-positioned should an exam or investigation occur. In this manner, managers are better able to focus on running their business and can avoid the harm that comes from mere allegations of wrongdoing and the extreme diversion of time and attention caused by a protracted investigation or examination.

If you have any questions about the adequacy of your disclosures or any of the topics addressed here please do not hesitate to contact us.

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[7] https://www.sec.gov/litigation/admin/2019/ia-5245.pdf