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What Private Equity Fund Managers Need to Know About SEC Examinations

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Prior to the passage of the Dodd-Frank Act, a private equity manager was exempt from federal regulation under the Investment Advisers Act of 1940 (the "Advisers Act") so long as it managed fewer than 15 private equity funds. The Dodd-Frank Act overhauled the regulatory landscape by requiring a private equity manager with at least $150 million of assets under management to register under the Advisers Act, regardless of the number of private equity funds it manages. There are exceptions to registration for managers who advise only small business investment companies or who qualify as a "family office." There are now over 1,000 newly registered investment advisers who manage private equity funds ("Managers") who must, among other things, annually file with the Securities and Exchange Commission Form ADV and Form PF, which is designed to enable regulators to gather information to assess systemic risk to the financial system, and submit to periodic SEC field examinations.

To date, the SEC's Office of Compliance Inspections and Examinations has completed field examinations of 150 Managers, and an additional 100 examinations are to be completed by year-end. The SEC has reported finding improprieties in more than 50% of the Managers examined. Most of the improprieties concern the allocation of expenses among the portfolio company, the private equity fund, other co-investors managed by the Manager, and the Manager itself, and the valuation of illiquid portfolio companies. This is not surprising since, unlike a hedge fund, which invests in noncontrolling minority stakes in numerous publicly traded companies about which there is robust ongoing public disclosure, a private equity fund acquires a controlling interest in a handful of privately held companies about which little is known. Since a Manager effectively controls the entire investment complex, including the portfolio company, there are conflicts of interest that require clear policies, concise disclosure of those policies, and robust compliance procedures to ensure that the disclosed policies are being followed.

Managers typically receive compensation in the form of an annual management fee, often between 1% and 2% of assets under management, to cover their ongoing expenses, and a carried interest, often 20%, of the fund's profits after achieving a minimum investment return. While Managers sometimes agree in the fund documents to offset any fees their affiliates receive from their portfolio companies against the management fee charged to the fund investors, investors may not be fully aware of the extent to which Managers and their affiliates collect fees from their vertical fund complex. Instead of functioning as a cost recovery mechanism, the receipt of management and advisory fees can become a significant profit center for a Manager.

Accentuating the problem, the SEC has found that fund documents are often vague as to (a) the expenses to be charged directly to the fund and the expenses to be borne by the manager, (b) the types of fees that can be charged to portfolio companies, and (c) procedures for addressing conflicts of interest, including the allocation of investment opportunities and busted deal costs. Most important, fund documents often lack an effective mechanism for investors to obtain information necessary to monitor their investment and the activities of the Manager. Another area of concern for the SEC centers on valuation policies and procedures contained in the fund documents and whether a Manager actually follows those policies and procedures.

The SEC's key concerns include:

1. The fees of consultants, or "operating partners," being charged to the fund or the portfolio company when those individuals appear to be part of the Manager's investment team.

2. Agreements where the portfolio company pays the Manager fees for monitoring services that may extend for a term beyond the typical investment holding period, and a termination fee being paid to the Manager to buy out the agreement upon the sale of the portfolio company.

3. The fund or portfolio company engaging service providers affiliated with the Manager for services of "questionable value."

4. Transferring employees of the Manager to the portfolio company.

5. Charging a fund directly for the cost of services such as legal, accounting, and compliance that had been previously paid by the Manager.

6. Broken deal expenses associated with generating deal flow being allocated solely to the fund but not to separately managed accounts that had committed to invest in the deal.

7. Using valuation methodologies different from the methodologies disclosed in the fund documents.

8. Changing valuation methodologies from period to period without explanation.

9. Cherry-picking comparables.

10. Using projections instead of actual valuations without appropriate disclosure.

Managers should review their business practices against their fund documents and consider appropriate adjustments to (a) ensure there exists a robust process and procedure for addressing inherent conflicts of interest, and (b) foster full disclosure and transparency, including with respect to expense allocation across a Manager's entire management complex and a consistent valuation process. Every Manager should prepare to address these areas of concern in its SEC exam and anticipate inquiries from its investors on these matters.

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