Paul|Weiss **Private Equity Digest**

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SEC's Office of Compliance Inspections and Examinations Warns of Deficiencies by Private Equity Fund Advisers

On May 6th, 2014, Andrew Bowden, Director of the SEC's Office of Compliance Inspections and Examinations, delivered a speech entitled "Spreading Sunshine in Private Equity". In his remarks, Mr. Bowden shared some areas of concern revealed during OCIE's recent presence exams of more than 150 newly registered private equity fund advisers. These exams come courtesy of the Dodd-Frank Act's requirements that certain private fund advisers register with the SEC and are another example of the agency's renewed enforcement focus on the financial industry in recent years.

Mr. Bowden outlined the following common deficiencies observed during these exams:

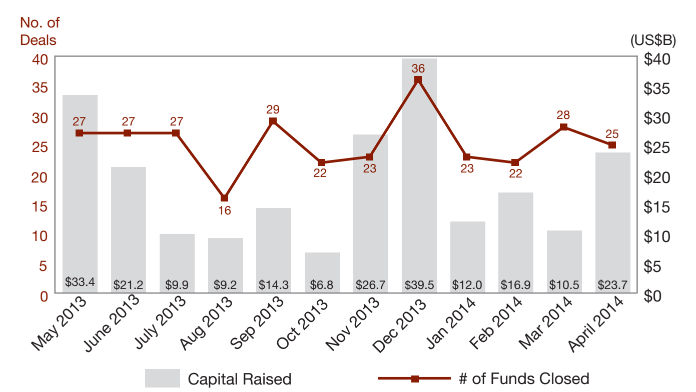
Fees and Expenses

Inadequate Policies. The most frequently observed deficiency, with over 50% occurrence, involved inadequate policies and procedures or inadequate disclosure to investors regarding an adviser's treatment of fees and the allocation of expenses among portfolio companies, the fund or the adviser.

Undisclosed Fees and Expenses. These deficiencies often involve undisclosed fees and expenses paid by the fund or portfolio companies to consultants or "operating partners" who provide services to portfolio companies. Since operating partners often are presented as members of the adviser's team, investors often do not realize that they are paying for the operating partners in addition to the management fee (and that such fees rarely offset the management fee). Another deficiency involved advisers charging fees that are not adequately disclosed to investors, including:

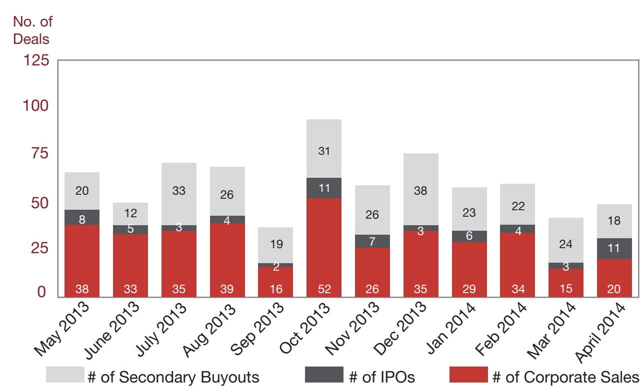
- the collection of accelerated monitoring fees by an adviser upon early termination of its monitoring agreement with a portfolio company;
- charging undisclosed administrative, transaction or other fees not contemplated by, or exceeding the limits set in, the limited partnership agreement (e.g., recapitalizations); or
- hiring related-party service providers who deliver services of questionable value.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

Shifting Expenses. Some advisers shift expenses from themselves (e.g., back-office compliance, legal or accounting costs that would typically be covered by the management fee) to their funds (and, therefore, investors) during the life of a fund without disclosure to investors.

Automation Services. Some advisers automate reporting functions and shift the related expense to investors, contrary to the reasonable expectation of investors under a fair reading of the limited partnership agreement ("LPA"). Prior to such automation, the preparation and delivery of these reports would have typically been performed by the adviser and covered by the management fee.

Valuation and Marketing

Valuation Methodology. A common issue is the use by advisers of a valuation methodology that is different from the one disclosed to investors. OCIE examiners scrutinize whether the actual valuation process aligns with the process that an adviser has promised and are watchful for the following tactics:

- cherry-picking comparables or adding back inappropriate items to EBITDA; and
- changing the valuation methodology from period to period without additional disclosure.

Marketing Materials. OCIE is carefully reviewing marketing materials to look for other inconsistencies and misrepresentations (e.g., performance marketing and misstatements about the investment team).

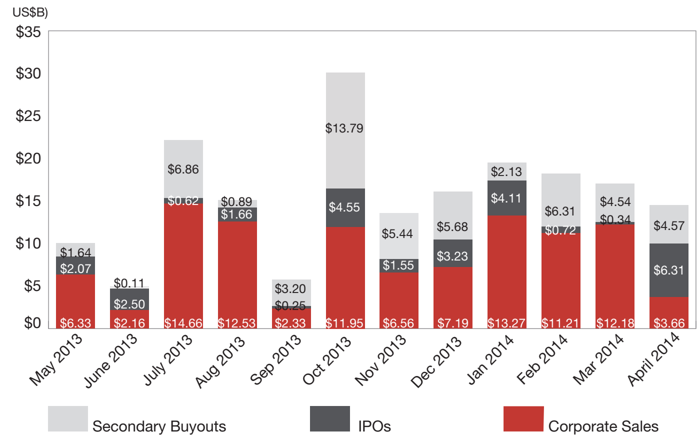
Limited Partnership Agreements

Overly Broad LPA. OCIE has observed that many LPAs are drafted too broadly regarding the types of fees and expenses that can be charged to portfolio companies, the fund or the adviser. This has created a grey area that allows investment advisers to charge fees and pass along expenses that are not reasonably contemplated by investors (such as the expenses relating to operating partners, automation services, administrative fees, etc. discussed above).

Poor Valuation Procedures. LPAs often lack clearly-defined valuation procedures, investment strategies and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.

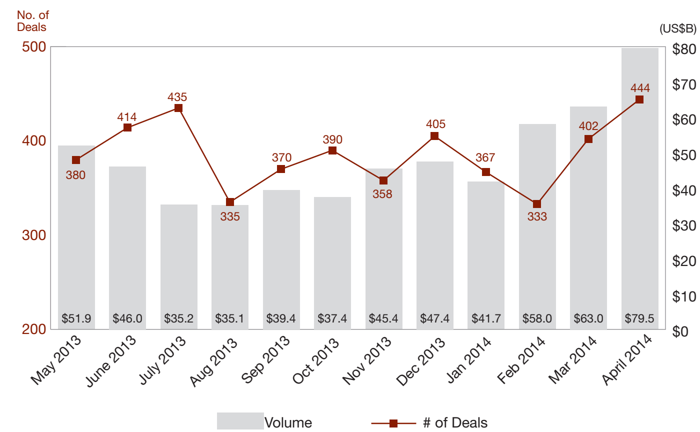
Insufficient Information Rights. Most LPAs contain insufficient information rights for investors to adequately monitor their investments and adviser operations. Broad, imprecise language in LPAs often leads to opaqueness. Bowden emphasized that the lack of transparency and limited investor rights have been the norm in private equity.

U.S. Sponsor-Backed Exits By Dollar Volume



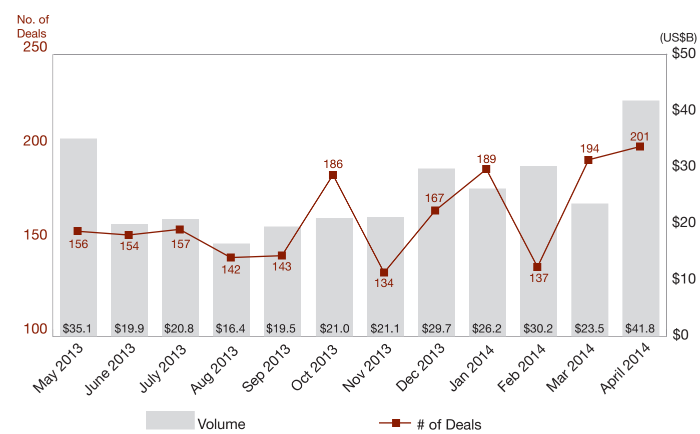
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

Accepted Lack of Transparency

Investors typically conduct substantial due diligence before investing in a private equity fund; however, investor oversight is generally much more lax after closing. This is especially true when a fund has completed its investment period.

Misaligned Interests between Advisers and Investors

Zombie Advisers. OCIE continues to see "zombie advisers" – that is, investment advisers that are unable to raise additional funds, but continue to manage legacy funds past their expected life. These investment advisers are incentivized to continue to profit from their current portfolio (e.g., by increasing their monitoring fees or shifting more expenses to the fund) even if doing so is not in the best interest of investors.

Conflicts of Interest. OCIE has seen the emergence of larger investment advisers with various business lines, such as separately managed accounts and co-investment vehicles. These new business models present conflicts of interest, governance and compliance issues that must be addressed as these firms mature and evolve.

Some of the above deficiencies have already resulted in recent enforcement action. Given this renewed SEC focus, private equity fund advisers should re-examine their practices in the areas highlighted above with an eye to spotting actual (or perceived) issues. As with most tasks that involve possible SEC scrutiny, the compliance and legal departments will be invaluable in this exercise.

For a copy of the complete speech, see, **http://www.sec.gov/News/Speech/Detail/Speech/1370541735361**

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