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## SEC Director Speaks on Spreading Sunshine in Private Equity

In a speech entitled “Spreading Sunshine in Private Equity” at the Private Fund Compliance Forum 2014 in New York yesterday, Andrew Bowden, Director of the SEC’s Office of Compliance Inspections and Examinations (“OCIE”), spoke about key issues that OCIE has identified since starting exams of the industry in October 2012. The SEC gained authority to oversee hedge funds and buyout funds with more than \$150 million in assets pursuant to the 2010 Dodd- Frank Act, and has a goal of inspecting 25% of newly registered private equity advisers by the end of the year.

Director Bowden reported that in over 50% of the 150 exams of private equity advisers that have been conducted to date, OCIE identified what it believes to be violations of law or material weaknesses in controls with respect to handling of fees and expenses. Director Bowden observed that broad characterizations of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser) under a fund agreement has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors. Notably, disclosure is often inadequate with respect to the following fees and expenses:

- **Operating Partners**: Director Bowden described the “operating partner model” adopted by many private equity firms as effectively a “back door” fee. Under this approach, consultants who are technically not affiliates or employees of the manager provide portfolio companies with consulting services, which are paid for by the fund or the portfolio company. As these consultants are often presented as full members of the advisor’s team, many investors do not realize they are not paid for by the manager or that their costs rarely offset management fees, which would otherwise typically be the case for affiliates or employees of the adviser.
- **Shifting Expenses**: Director Bowden noted a trend of advisers shifting expenses from themselves to their clients during a fund’s life, for example by charging the cost of software and automated reporting to investors, rather than to the adviser, who previously paid employees to produce reports manually.
- **Hidden Fees**: Director Bowden highlighted issues with hidden fees, such as accelerated monitoring fees, charging undisclosed “administrative” or other fees not contemplated by the fund agreement, exceeding limits set in the fund agreement around transaction fees in cases not contemplated by the fund agreement (e.g., recapitalizations) and hiring related-party service providers, who deliver services of questionable value.

Director Bowden also described valuation as an expected key risk area in marketing and reporting in the future, noting that in its exams, OCIE scrutinizes whether the actual valuation process used by an adviser aligns with the process promised to investors. Examiners

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specifically look out for cherry-picking comparables, adding back inappropriate items to EBITDA or changing the valuation methodology from period to period coupled with inadequate disclosure and/or inadequate rationale for these actions. Examiners also focus on performance marketing (where projections might be used in place of actual valuations without proper disclosure) and misstatements about the investment team (especially where key team members resign or announce a reduced role soon after a fund-raising is completed).

Director Bowden also touched on other observations stemming from the OCIE examinations, including that fund agreements often lack clearly defined valuation procedures, investment strategies, protocols for mitigating certain conflicts of interest and provisions giving investors sufficient information rights to adequately monitor their investments and the operations of their manager. Speaking on industry trends, he noted ongoing consolidation and shake out in the private equity industry resulting in both “zombie advisors” (managers unable to raise additional funds who continue to manage legacy funds long past their expected life) on one hand and larger and more diversified managers (who may struggle with governance and compliance issues related to their added complexity and rapid growth) on the other.

Finally, in addition to noting the importance of setting the correct tone for compliance at the top, Director Bowden stressed that the effectiveness of a firm’s compliance department is enhanced by the integration of compliance officers into the firm’s business. He stated that advisers whose compliance officers participate in weekly deal meetings or meetings with investors, or who review deal memos, for example, tend to be more effective issue spotters and their firms tend to be more compliant.

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Please feel free to call any of your regular contacts at the firm or any of our partners and counsel listed under “[Private Equity](#)” in the “Practices” section of our website (<http://www.clearygottlieb.com>) if you have any questions.

The speech is available on the SEC’s website at <https://www.sec.gov/News/Speech/Detail/Speech/1370541735361#.U2i9qIFdUvk>.

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