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Client Alert

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THE SEC'S PRIVATE EQUITY "INITIATIVE" LEAVES NO STONE UNTURNED: TIME TO TAKE A HARD LOOK AT YOUR COMPLIANCE PROGRAMS

In March, the SEC settled two enforcement actions involving private equity. The two actions are just the latest indicators of the SEC's wide ranging and close scrutiny of the private equity industry, which has been ongoing for some time. We are hearing multiple speeches by SEC Staff focused on perceived compliance problems in the private equity industry. Focusing on both registered and unregistered investment advisers, the SEC has expressed concern with virtually every type of violation, large and small, of which a private equity investment adviser is capable. From the manner in which the offering is conducted to violations of fiduciary duties -- improper valuations of portfolio assets, conflicts of interest, favoring some clients over others, improper use of unregistered broker-dealers and finders, general solicitation in private placements, inaccurate disclosures – nothing is being overlooked.

The SEC's "Private Equity Initiative"

For well over a year, the SEC Enforcement Division's new Asset Management Unit (AMU) has been heavily targeting private equity. The AMU has recruited industry professionals with asset management experience to serve as specialists on the unit, including private equity specialists. The unit is leveraging this expertise to ferret out wrongdoing in the industry. In January of this year, AMU Chief Bruce Karpati explained why the SEC thinks it is important to focus on private equity:

> Private equity went through a significant growth spurt in the run-up to the financial crisis and is a rapidly maturing industry. In terms of assets under management, it's roughly equivalent to, and perhaps larger than, the hedge fund industry. Also, many private equity managers have only recently become registered investment advisers. As a result of these developments, it's not unreasonable to think that the number of cases involving private equity will increase. Many in the private equity industry have pointed to the greater perceived alignment of interests in private equity products — for instance, in the way carried interest is paid on realizations and not on net asset values but private equity has other unique characteristics that may make the industry more susceptible to fraud, for example, the ability to control portfolio companies in a way not completely transparent to investors.

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Mr. Karpati expressed concern that in the private equity industry currently, "there is more capital chasing the same number of deals, which puts extra pressure on returns," in turn creating a heightened incentive for "inappropriate" behaviors.

Enforcement Casting a Wide Net

The Enforcement Division appears to be taking a shotgun approach in its targeting of private equity. Staff has expressed concern over a wide array of issues in speeches and other informal communications. Actual enforcement actions also involve a wide array of offenses. In 2012, the private equity specialist on the AMU stated that nearly every private equity firm examined had a variety of different "issues" of varying size and scope.

In 2010, the head of the Enforcement Division described an intention to apply the "broken window" theory to SEC enforcement, under which the agency deliberately seeks to ferret out and pursue violations that may seem minor in nature. The notion behind this criminological theory is that better policing of minor infractions will lead to less serious crime as well by creating an overall heightened culture of compliance. Along a somewhat similar theme, last year the AMU instituted "Operation ADV," in which the unit scrutinizes Forms ADV (filed by registered investment advisers). Among other things, the unit is paying close attention to the disclosures made about the educational background of, and other biographical information disclosed by, advisers. These are items that an investment adviser may not intuitively expect to receive such close scrutiny by enforcement staff.

Unregistered Advisers Are Not Beneath the Radar

It might be tempting to think that unregistered advisers are beneath the AMU's radar. As a practical matter, it probably is, to a certain extent, more difficult for the AMU to subject unregistered advisers to the same level of scrutiny. Certainly, the AMU's investigatory powers are far less sweeping with regard to unregulated entities, as to which they need a subpoena. This does not mean, however, that unregistered advisers are outside the scope of the current enforcement initiative.

In December of 2012, AMU Chief Bruce Karpati expressed concern about unregistered advisers. Apparently thinking ahead to the Congressionally mandated (but not yet enacted) lifting of the ban on general solicitation in 506 offerings, he particularly noted a risk that unregistered advisers may engage in general solicitation without proper policies to ensure that only accredited investors invest.

It is worth noting as well that an investment adviser with valid registration exemptions is nonetheless subject to the anti-fraud provisions of the Investment Advisers Act, as well as a "duty to supervise." The SEC has used these provisions to bring enforcement actions against unregistered advisers in the past. Thus, lack of federal registration does not render an investment adviser immune to federal enforcement activity.

Top Issues of Concern

In early 2012, the then-head of the AMU described a host of areas of particular concern. In a speech delivered in January of this year, current head Bruce Karpati largely echoed these same issues, expressing concern about:

- Inappropriate marketing practices;
- Valuation of illiquid assets, especially during fund raising;
- Inappropriate use of data from older realized investments to market new investments;
- The conflict of interest between the profitability of the management company and the best interests of investors, especially where management company shares are publicly traded;
- Shifting expenses from the management company to the funds (for example, using the funds' purchasing power to get "deals" for the management company for legal and accounting services);
- Charging additional fees that are not clearly provided for by the partnership agreement;
- Favoring some clients over others, especially with regard to "broken deal" expenses;
- Shifting organizational expenses to a co-mingled vehicle to favor preferred clients;
- Using one vehicle to make fund commitments to create "deal flow" for a more profitable co-investment vehicle;
- Conflicts involving other businesses of the manager, increasing the risk of usurpation of business opportunities or unfair related-party transactions.

Mr. Karpati also discussed so-called "zombie funds," funds that have little hope of generating profits but remain unliquidated long after that has become clear. Management companies continue to charge fees for managing the often illiquid assets, raising questions about how the assets are valued. Karpati noted that it is not unlawful to manage a zombie fund, and that most zombie fund managers do continue to act in the best interests of their clients. However, he believes that the nature of zombie funds creates heightened incentives for managers to engage in "problematic conduct" and "possible violations of the law." Thus, the "Private Equity Initiative" is taking a harder look at managers who have assets under management but cannot raise new funds, and funds with unusually low liquidity.

Although the AMU has described these specific items as areas of particular concern, these are not the only types of issues on their radar. As noted above, the Enforcement Division is casting a wide net.

March Cease-and-Desist Orders

On March 11, 2013, the SEC announced the settlement of two enforcement actions involving private equity firms. Set forth below are brief summaries.

Ranieri Partners – use of unregistered broker-dealer. The SEC fined Ranieri Partners $375,000 for using an unregistered broker-dealer to market two of its funds. In 2008, William Stephens, who had previously been barred from the industry, was hired as a "consultant" to locate potential investors for two separate funds. The SEC found Stephens went beyond the role of a finder by actively soliciting investors and receiving transaction-based compensation. Among other things, Mr. Stephens distributed offering materials, actively sought to persuade individuals to invest, and communicated his personal analysis of the funds' strategy and performance track record. The defendants neither admitted nor denied the allegations. The SEC ordered Mr. Stephens to disgorge over $2 million of commissions but waived payment due to his financial condition; Donald Phillips, the former senior managing director who hired Stephens, was fined $75,000. Stephens agreed to a lifetime bar from working in the industry, and Phillips agreed to a nine-month suspension. The SEC noted that in approving the settlement, it had taken into consideration remedial efforts made by Ranieri Partners, which had in 2011 adopted new policies and procedures designed to prevent the use of unregistered broker-dealers.

Oppenheimer & Co. – misleading disclosures about valuation. In related SEC and Massachusetts settlements, Oppenheimer & Co. agreed to disgorge nearly $3 million for making inaccurate statements regarding the valuation of a portfolio company, bringing to a close an investigation that reportedly began in 2011. The allegations centered around the holdings of an Oppenheimer fund of funds (Oppenheimer Global Resource Private Equity Fund I, L.P., or "OGR") in a fund called Cartesian Investors-A.

Cartesian Investors-A was OGR's largest holding. In turn, Cartesian Investors-A's portfolio consisted entirely of shares in S.C. Fondul Proprietatea SA, a fund created by the Romanian government to compensate citizens whose property was confiscated by the communist regime. These citizens were compensated with shares in the Fondul Proprietatea fund, based upon a "par value" of one Romanian leu per share. From the inception of OGR in 2007, OGR had valued all of its investments (including Cartesian Investors-A) based on the valuations of portfolio company managers. However, at the end of October 2009, OGR's portfolio manager changed valuation methods: instead of using Cartesian's valuation of the Fondul shares, OGR used the par value. According to the SEC, this mark-up alone increased OGR's reported internal rate of return from 3.8% up to 38.3% for the quarter of ended June 30, 2009.

As it happens, Oppenheimer was marketing OGR at the time. Not only did the performance summary tables state via footnote that the valuation was based on the underlying manager's valuation, but sales staff actively touted the apparently high internal rate of return and the increase in performance of the Cartesian/Fondul holdings, without disclosing that the numbers were materially inflated by a change in valuation method. The SEC also found that Oppenheimer employees falsely stated that the Cartesian/Fondul holdings had been valued by a third party firm used by Cartesian, and that all of OGR's underlying funds were subject to an independent audit, although the Cartesian fund was not audited.

In addition to the disgorgement, Oppenheimer is required by the settlement to retain an independent consultant to review and make revisions to its compliance program. Oppenheimer is required to retain the independent consultant for at least two years.

More on Broker-Dealer Registration Issues

Following the announcement of the Ranieri Partners settlement, in early April David Blass, Chief Counsel of the SEC's Division of Trading and Markets, specifically addressed the use of finders "in the private fund space" in a speech to the ABA Trading and Markets Subcommittee. Mr. Blass echoed the Enforcement Division's views about the increasing significance of the private equity industry, and described a very specific concern at the SEC about the illegal use of unregistered broker-dealers by private equity firms. He stated that their reviews of the many newly registered investment advisers (due to changes in the registration requirements made by Dodd-Frank) have revealed to them widespread problems in this area.

While the Ranieri Partners case described above involved the use of an "independent contractor" to solicit investors, Mr. Blass expressed concern about the use of employees. He discussed two particular types of scenarios that the Division has recently become especially concerned with:

- the "plain vanilla" flavor, in which a fund adviser pays personnel transaction-based compensation for selling interests in a fund, or has personnel whose only or primary functions are to sell interests in the fund; and

- the "dark chocolate" flavor, in which the adviser, its personnel or affiliates receive transaction-based compensation for purported investment banking or other broker activities relating to one or more portfolio companies.

Mr. Blass echoed the "broken windows" philosophy, pointing out while use of an unregistered broker-dealer may seem like a "technical" violation, in the Commission's view, a willingness to act as an unregistered broker may be an indicator of a willingness to engage in other potential misconduct. Mr. Blass also reminded companies that use of an unregistered broker-dealer may give investors a rescission right – a practical reason to worry about more than just an enforcement action.

Limited Partner Advisory Committees

It is worth noting here that recently the SEC's Enforcement Division specifically recommended that private equity funds use LP Advisory Committees to resolve issues surrounding conflicts of interest. Referring to their use as "[o]ne of the best, easiest and most underutilized ways to ensure that your firm and its principals are meeting their fiduciary responsibilities and being transparent with investors," AMU Chief Bruce Karpati indicated that disclosing conflicts to such a committee (or even better, have the committee approve them) would be taken as evidence of "good faith." For more information about this increasingly popular governance device, please see "An Overview of Limited Partner Advisory Committees and Private Equity Fund Advisory Boards" in our January/February issue.

Conclusion and Recommendations

The *Ranieri Partners and Oppenheimer & Co.* cases, together with repeated SEC Staff pronouncements, underscore a continued, heightened focus on the private equity industry by regulators. Examiners and enforcement personnel are working hand-in-hand to ferret out wrongdoing in the industry. They have expressed a specific intention to concern themselves with violations that do not involve fraud and that may seem minor, seeing these as possible indicators of possible greater wrongdoing.

The laundry list of types of violations the SEC is concerned with is lengthy and non-exhaustive, covering virtually every type of violation of which a management company is capable. From conflicts of interest and other violations of fiduciary duties to improper valuation to violations during marketing such as general solicitation, use of unregistered broker-dealers, and inaccurate disclosures. And the list goes on to include insider trading, false statements on Forms ADV, failure to supervise, and failures to implement appropriate compliance procedures and controls. In short, there seems to be no type of violation – big or small – that is not on their radar.

Registered advisers in particular, with respect to whom the SEC has virtually plenary investigatory powers, need to take steps to address any defects in their compliance programs, if they have not already done so. Unregistered advisers should not assume that they are immune, however, and should focus on the legal requirements that do apply to them. Most of the areas of concern to SEC Staff apply widely to unregistered advisers as well. The Enforcement Division has signaled a special concern with unregistered advisers.

SEC Staff has more than once stated that companies who discover and promptly remediate flaws in their compliance programs will get credit for that in a subsequent investigation. The Ranieri Partners case is a good example of that. For that reason, today is an excellent time to re-evaluate and fortify your compliance programs.