SEC Warns: "the number of cases involving private equity will increase."

On January 23, the Chief of the Securities Exchange Commission's Asset Management Unit ("AMU"), Bruce Karpati, participated in a question and answer session at the Private Equity International Conference. He discussed the SEC's plans for oversight of the private equity industry and said that "it's not unreasonable to think that the number of cases involving private equity will increase."

The recent nomination of Mary Jo White for SEC Chairman further highlights the increased emphasis placed on enforcement. When he nominated Ms. White, President Obama emphasized this theme, stating that "it's not enough to change the law. We also need cops on the beat to enforce the law."

Effect of Asset Management Unit on SEC's Private Equity Activities

The AMU was formed as a distinct group in 2010. The unit has focused on "generating expertise" in the areas it covers. It has hired industry specialists, including people hired from private equity firms. According to Mr. Karpati, these efforts have helped the AMU identify "promising cases" for enforcement earlier.

Mr. Karpati also described the AMU's efforts to collaborate across the SEC where possible. One significant area of collaboration has been with the SEC's National Exam Program. AMU personnel have helped train examiners and have accompanied them on exams of private equity managers.

Current and Future SEC Enforcement Focus on Private Equity

While recognizing that the "list is always evolving," the AMU is generally focusing attention on "areas that lack transparency, where fraud may occur undetected, or where there may be ambiguity that creates the opportunity to engage in fraud." Mr. Karpati named several specific private equity "industry stressors" that are likely to be areas of focus:

- **Fundraising and Capital Overhang:** The recent rapid growth and subsequent contraction in fundraising has resulted in high capital overhang—the gap between funds raised and equity invested. Mr. Karpati argued that since this capital will eventually expire, there is more capital chasing fewer deals, which in turn puts "extra pressure on returns" and incentives to engage in "aggressive marketing."
- **Lack of product transparency and manipulation of valuations:** Mr. Karpati and AMU have concerns about what they view as a lack of transparency in private equity products, especially with respect to the valuation of illiquid assets and the operations of portfolio companies. This lack of transparency could create opportunities to manipulate valuations, particularly during fund marketing. Mr. Karpati specifically pointed to situations where AMU has seen managers write up the value of assets during fundraising, and then write them down after fundraising closes.
- **Conflicts of interest:** While acknowledging that "conflicts of interest are a natural part of the private equity business," Mr. Karpati spent significant time discussing the risks they pose. Conflicts, he said, "can lead to misappropriation, deal cherry picking and other forms of misconduct." He listed several common types of conflicts of interest that AMU sees in private equity firms: (1) the conflict between profitability of the manager and the best interests of investors; (2) the shifting of expenses from the manager to the funds, including using funds' buying power to get better deals from vendors for the management company at the expense of the fund; (3) charging additional fees to portfolio companies where the allowable fees are poorly defined by the partnership agreement; (4) managing different

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clients, investors and products under the same umbrella, which leads to broken deal expenses rolled into future transactions that may be paid by other clients, shifting of organizational expenses to commingled funds to the benefit of preferred clients, and complementary products supporting each other to create more deal flow for a more profitable investment vehicle; and (5) conflicts with a manager's other business that may be run in parallel with the adviser, which can lead managers to usurp investment opportunities or enter into related party transactions at the expense of investors.

- **Co-investments:** Mr. Karpati warned that "managers who offer co-investment opportunities only to certain favored clients may be violating their fiduciary duty to other clients who may also be interested in such opportunities." Mr. Karpati did not explain whether he considers the funds or its investors to be the "clients" for purposes of this analysis.

Mr. Karpati also specifically cited a number of recent enforcement actions as indicative of the type of misconduct that can occur in private equity firms:

- **Usurpation of investor opportunities:** In the *Matthew Crisp* action, an individual allegedly redirected an investment opportunity from private equity funds managed by Adams Street to a fund that he co-managed, the existence of which was not disclosed to Adams Street or its investors. *In re Crisp*, Adm. Proc. File No. 3-14520 (instituted Aug. 30, 2012).
- **Misallocation of expenses:** In the *Robert Pinkas* action, the principal of private equity manager Brantley Capital allegedly used funds from a private equity fund to pay for his defense in an unrelated SEC action. *In re Pinkas*, Adm. Proc. File No. 3-14759 (instituted Feb. 15, 2012).
- **Misrepresentations to investors:** In the *Advanced Equities* action, a broker dealer allegedly made misstatements to investors about the performance of a portfolio company. While this case did not involve a private equity firm, Mr. Karpati cited it as an example of conduct that AMU might see in private equity. *In re Advanced Equities, Inc.*, Adm. Proc. File No. 3-15031 (instituted Sept. 18, 2012).
- **Pyramid schemes:** In *SEC v. Resources Planning Group*, a private equity principal allegedly used fund assets to repay previous investors. No. 12-cv-9509 (N.D. Ill. Filed Nov. 23, 2012).
- **Improper fees:** In *SEC v. Onyx Capital Advisors, LLC*, the principal of Onyx Capital allegedly took $2 million from his fund, supposedly as an "advance management fee." No. 10-cv-11633 (E.D. Mich. Filed April 22, 2010).
- **Insider trading:** In *SEC v. Gowrish*, a private equity firm employee allegedly stole confidential acquisition information and sold it for use in trading. No. 09-cv-5883 (N.D. Cal. Filed Dec. 16, 2009).
- **Value inflation:** In *SEC v. Yorkville Advisors*, a hedge fund allegedly inflated illiquid asset values. No. 12 Civ. 7728 (S.D.N.Y. filed Oct. 17, 2012). The valuation issues present in *Yorkville* are, Mr. Karpati said, "very similar to ones we see in private equity."

Risk Analytic Initiatives

Mr. Karpati also spoke about the use of "risk analytic initiatives," or RAIs, as part of the SEC's assessment of private equity firms. RAIs are used "to proactively detect problematic conduct through the use of data and quantitative methods." For private equity, they are designed using, among other things, AMU's expertise in identifying "high risk areas that lack transparency, are not monitored by investors, or have some other quality indicative of fraud."

A current initiative seeks to use RAIs to identify managers with assets under management that are unable to raise new vehicles. Mr. Karpati refers to these managers as "zombie managers," and considers them to be a significant potential source of illegal behavior. Zombie managers appear when holdings are unable to be quickly liquidated. Unable to raise new capital, they may shift their efforts from benefiting investors to maximizing their own revenue. To locate these managers, the RAIs assess data about fund portfolios and look for those with low liquidity for additional attention.

Role of CCOs, COOs and CFOs in Reducing Risk

Finally, Mr. Karpati advised private equity COOs, CFOs, and CCOs on how to reduce the risk of enforcement actions. He made recommendations in four areas:

- Mr. Karpati stated that CCOs, COOs and CFOs are "absolutely critical" in protecting client interests from wayward managers and principals and should act as "investor advocates." Investment advisers have a fiduciary duty to their clients, he continued, and the AMU will view many of its investigations through the fiduciary duty lens.
- Firms should integrate compliance risk into their risk management process, Mr. Karpati advised. COOs, CFOs, CCOs, and other risk managers, he said, should have access to the firm's decision-making processes and should sit on important committees such as the investment committee to ensure transactions are at arm's length.
- COOs, CFOs, and CCOs should use the Limited Partnership Advisory Committee to help ensure the investment adviser is meeting its fiduciary responsibilities and transparency obligations, Mr. Karpati said. These committees often have responsibility in these areas, but AMU has observed that many managers do not use them. Mr. Karpati advised that disclosure of conflicts to the Advisory Committee also demonstrates good faith in the case of an investigation or enforcement action.

Mr. Karpati encouraged COOs, CFOs, and CCOs to be alert and prepared for exam inquiries. When inquiries occur, they should cooperate with the SEC, he said. After an inquiry, he continued, it is important to correct deficiencies identified by the SEC. Doing so "will help the examination process to proceed more efficiently and reduce the likelihood of more formal inquiries by the Enforcement Division or AMU staff," he concluded.

If you would like further information, please contact the Ropes & Gray lawyer that usually advises you.

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