Latham & Watkins Securities Litigation & Professional Liability Practice

December 8, 2014 | Number 1773

Private Equity Fund Managers: Takeaways From The SEC's Past Year in Enforcement

After a year of "first ever" actions targeting private equity, fund managers should be vigilant, even about seemingly small issues.

In reviewing the results of SEC Enforcement's fiscal year that ended on September 30, the agency congratulated itself on its comprehensive approach to enforcement and its "first-ever" cases. Private equity fund managers should consider a number of important takeaways.

The SEC Continues to Pursue a Broken Windows/Zero Tolerance Approach

Although the Enforcement Division announced a record number of enforcement actions, and the largest aggregate financial recovery, 2014, unlike in years past, did not include a headline-grabbing case such as Enron, Worldcom or Madoff. More recently, the agency has chosen to emphasize its pursuit of smaller cases as a way of improving compliance in the industry. SEC Chair Mary Jo White and Enforcement Director Andrew Ceresney have each touted the agency's "broken windows" approach to enforcement. A "broken windows" strategy means that the SEC will pursue even the smallest violations on the theory that publicly pursuing smaller matters will reduce the prevalence of larger violations. Ceresney has described "broken windows" as a zero tolerance policy. This past year illustrated the agency's commitment to applying enforcement sanctions to what some might consider "foot fault" incidents. For example, in September 2014, the SEC announced a package of three dozen cases involving a failure to promptly file Section 13D and Section 13G reports, as well as Forms 3 and 4. Many of the filers charged were just days or weeks late in disclosing their positions. In announcing the cases, Ceresney emphasized that inadvertence was not a defense to late filings.

The SEC Wants to Make a Mark in the Private Equity Space

The SEC has spent a considerable amount of time talking about private equity in the past fiscal year. Notably, Andrew Bowden, the head of the SEC's National Exam Program, delivered a speech titled "Spreading Sunshine in Private Equity" in May 2014. In this speech, Bowden chided the private equity industry for a lack of transparency, particularly as to fees earned by managers and charged to investors and portfolio companies. Furthermore, Bowden stated that more than half of the presence exams of PE fund managers revealed "violations of law or material weaknesses in controls."

The SEC also touted two private equity cases it brought in the past fiscal year as "first-ever" cases.

- In the *TL Ventures* case, the SEC's first-ever action under the Advisers Act "pay to play" rule (Rule 206-4(8)), the SEC charged a private equity fund manager with violating the Rule based on two separate political contributions by a management company employee totalling US$4,500. Under the Rule, the employee's contributions barred the fund manager from accepting management fees from two public pension plans that could be influenced by the political candidates that received the contributions. In announcing the case, Ceresney stated that "we will hold investment advisers strictly liable for pay-to-play violations."

- The SEC described the *Clean Energy Capital, LLC* case as its "first action arising from a focus on fees and expenses charged by private equity firms." In *Clean Energy*, the SEC alleged that the management company and its president improperly charged US$3 million in expenses to their funds. The allegedly inappropriate charges included the management company's rent and compensation and benefits of the employees.

The SEC followed *Clean Energy Capital* with the *Lincolnshire* case, in which the agency again brought fraud charges based on a private equity fund manager's misallocation of expenses. In *Lincolnshire*, two affiliated private equity funds agreed to share the expenses of a portfolio company in which each held an investment. The SEC alleged that the fraud arose from "misallocated and undocumented" expenses for the portfolio company, and a favoring of one fund over another.

What is Around the Corner for the SEC and Private Equity?

Fund managers should heed the messages that the SEC has been sending about its view of private equity since the messages may be harbingers of things to come. In the past two years, SEC enforcement actions have followed warnings by SEC staff members in public speeches. For example, in 2013, the Chief of the SEC's Asset Management Unit gave a speech on private equity that warned against using inflated interim valuations while raising a new fund. Later that year, the SEC announced the *Oppenheimer* and *Williamson* enforcement actions, in which the agency charged managers with violations related to the use of inflated interim valuations in fund marketing materials.

This year, the SEC followed Bowden's "Spreading Sunshine" speech with the *Lincolnshire* action. The relationship between staff speeches and enforcement actions is not surprising. Before a senior official of the SEC gives a major policy speech, they generally canvass staff members to see what sorts of investigations in the pipeline are likely to lead to "message cases" in the specific subject area. As a result, statements in SEC speeches often foretell future enforcement actions.

Similarly, the SEC's investment adviser exam program likewise sends its own signals, through staff speeches, announced priorities, the requests made in exams and comments made in deficiency letters.

Most recently, the SEC has been signaling its attention to performance advertising and reporting by private equity fund managers. The "Spreading Sunshine" speech provided an indicator — stating that the exam staff views marketing and valuation as a key risk area. Reuters recently reported that SEC examiners are probing the IRRs included in fund marketing materials. According to Reuters, the SEC is focusing on whether fund managers are including the general partner's (GP's) capital commitment when calculating net IRR. Including GP commitments could inflate the IRR, since the GP does not generally pay fees or carry on its committed capital. The SEC's focus on IRRs should not be a surprise, given that the agency stated in the January 2014 announcement of the National Exam Program's priorities that the exam staff would be analyzing advisers' performance advertising in marketing materials.

Private equity managers can expect the SEC exam staff to scrutinize performance claims in fund marketing materials. As a result, fund managers should ensure they re-evaluate their performance disclosures, in particular as to the transparency of performance calculations. Given the SEC's aggressive posture and willingness to pursue enforcement investigations and actions in the private equity space, such proactive steps are appropriate.

Conclusion

As past is prologue, fund managers should assume that the signals in SEC staff speeches are accurate predictors of enforcement priorities. Given the relatively low threshold of the enforcement actions in the past year, managers should be vigilant about addressing even relatively minor non-compliance issues.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

John J. Sikora Jr.
john.sikora@lw.com
+1.312.876.6580
Chicago

Nabil Sabki
nabil.sabki@lw.com
+1.312.876.7604
Chicago

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