Spreading Sunshine in Private Equity

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Introduction

Good morning, and thank you very much for that kind introduction. Before I begin, I'll remind you that the Securities and Exchange Commission disclaims responsibility for any statement or private publication by any of its employees, including me. The views expressed here are my own and do not necessarily reflect the views of the Commission, the Commissioners, or of other members of the staff.

I want to thank Private Equity International for giving me the opportunity to speak with you at an interesting moment in private equity regulation.[1]

According to at least one industry source,[2] since the beginning of the millennium, the private equity industry's assets under management, defined as the uncalled capital commitments plus the market value of portfolio assets, have increased year after year. With the industry-wide portfolio value increasing steadily, and dry powder remaining around the $1 trillion mark, private equity assets under management are higher than they've ever been at just under $3.5 trillion as of June 30, 2013.

In addition, over the last two years, many of your firms have registered with the Commission and are operating as regulated entities. I am hopeful that regulation will have a positive effect on your firms and your industry. Intelligent regulation can enable an asset class to grow by increasing investor confidence in investment models, programs, and products, including those offered by private equity firms.

Within OCIE, we have been sharpening our understanding of the private equity industry and our strategies to engage with you to fulfill our important mission to protect investors and the integrity of our markets. I want to take this opportunity to speak today to share where OCIE is in its efforts to engage with the private equity industry and also to share some insights we have learned from the examinations of private equity advisers we have conducted over the last two years.

OCIE and Presence Exams

OCIE consists of approximately 900 examiners who go out into the world and directly engage with registrants for the purpose of collecting information for the Commissioners and our colleagues on the staff. We are the "eyes and ears" of the Commission. We are responsible for conducting examinations of more than 25,000 registrants, including approximately 11,000 registered investment advisers, of which at least 10% provide services to at least one private equity fund.

We are well prepared and equipped to conduct these exams. Many of our examiners have conducted private equity exams. We have also added individuals with private equity expertise to our team. We maintain a specialized working group of private equity experts across the Commission, who help us identify issues, develop examination modules, evaluate exam findings, and conduct training. You may have also seen that we are forming a special unit of examiners, who will focus on leading examinations of advisers to private funds.

Presence Exam Initiative

The Presence Exam Initiative is an important part of our strategy to engage with the private equity industry. The initiative commenced in October 2012 and is nearly complete. As the name suggests, we designed the initiative to quickly establish a presence with the private equity industry

and to better assess the issues and risks presented by its unique business model. We began by reaching out to the industry, publishing letters, and appearing at events like this to share information about regulatory obligations and to be as transparent as possible about where we see risks and where we therefore intended to probe, to test, and to ask questions during examinations.

Some questioned why we would show our hand in this way, to which there's a simple and sensible answer. We believe that most people in the industry are trying to do the right thing, to help their clients, to grow their business, and to provide for their owners and employees. We therefore believe that we can most effectively fulfill our mission to promote compliance by sharing as much information as we can with the industry, knowing that people will use it to measure their firms and to self-correct where necessary. Put another way, we are not engaged in a game of "gotcha."

Which reminds me of a story and formative experience. Many, many years ago, I had the pleasure of serving on the Ocean City, Maryland beach patrol. As a new guard, or a "green bean" as we were called, I was assigned to apprentice with a sun-worn, grizzled veteran. One of the first things he explained to me was that because the Beach Patrol measured "pulls," or how many endangered swimmers a guard pulled from hazard, there were some guards who would watch idly while swimmers, through ignorance or neglect, swam themselves into danger, so the guard could jump from the stand and save them. My mentor explained the more effective, responsible approach was to work hard to prevent swimmers from getting into trouble in the first place. He encouraged me to hop off my stand, to speak with swimmers, and to warn them while they were still near shore or a safe distance from a jetty or riptide. The most effective guard, he explained, should rarely have to make a pull.

The same principle was behind our Presence Exam strategy and much of what we do every day, and it's behind the information I am sharing today, some of which is not flattering. I share it not to embarrass or to wag a finger, but to educate so all of the good people in attendance (or reading this speech) can test for and, if necessary, address within their organizations the types of problems we have seen across the industry.

After engaging with the industry in the initial phase of the Presence Exam Initiative, we commenced examinations. At this point, we have initiated examinations of more than 150 newly registered private equity advisers. We are on track to complete our goal of examining 25% of the new private fund registrants by the end of this year. Based on the feedback we have received, we believe the initiative has been effective and well received. (I welcome your candid feedback in this regard, whether it is consistent with, or contradicts, our belief.) The exams we have conducted to date have also led to some interesting insights, which I'll discuss in a moment.

Trends in Private Equity Industry

Many people ask how we determine our private equity exam priorities and risk areas. For starters, we analyze the incentives created by various industry structures and trends and use that analysis to determine where compliance failures are most likely to occur. We conduct exams, test our hypotheses, and learn. As the industry structures and trends shift, so too does our view of compliance risks.

Inherent Risks in Private Equity

When we look at the private equity business model, we see some risks and temptations that are not present in the more common adviser model where an adviser buys and sells shares of publicly traded companies.

A typical buy-side adviser uses client funds to buy shares in a publicly traded company. The adviser can vote proxies and may engage with management and the board up to point ... but absent taking some extraordinary steps, the adviser's ability to influence or control the company is generally constrained. If the adviser jumps through the hoops necessary to attempt to influence or

control the company, and accumulates (alone or with others) enough shares to pull it off, its control and the changes it intends to make are generally visible to its clients and the public at large.

The private equity model is very different. A private equity adviser typically uses client funds to obtain a controlling interest in a non-publicly traded company. With this control and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend. For example, the private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services ... or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company ... or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.

We have seen that these temptations and conflicts are real and significant.

Next, I'd like to identify some aspects of the industry that not only make it difficult to mitigate these risks, but also may enable them to flourish.

Limited Partnership Agreements

General Partners often point to the heavily negotiated and voluminous limited partnership agreement as a source of investor protection. But we've seen limited partnership agreements lacking in certain key areas.

Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors. Poor disclosure in this area is a frequent source of exam findings. We've also seen limited partnership agreements lacking clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.

Finally, and most importantly, we see that most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager. Of course, many managers voluntarily provide important information and disclosures to their investors, but we find that broad, imprecise language in limited partnership agreements often leads to opaqueness when transparency is most needed.

Lack of Transparency

Lack of transparency and limited investor rights have been the norm in private equity for a very long time. While investors typically conduct substantial due diligence before investing in a fund, we have seen that investor oversight is generally much more lax after closing.

There could be many reasons for this. Investors may not be sufficiently staffed to provide significant oversight of managers. When they are, and even when they conduct rigorous due diligence up front, they often take a much more hands-off approach after they invest their money and funds are locked up. This is especially true when managers have completed their investment period and the investor does not plan to reinvest. There is a high cost to initiating action among limited partners, especially after their capital has been substantially drawn and when there are many investors in a fund, who are difficult to organize or even identify. Or, there may be a mistaken belief that auditors will provide sufficient oversight to protect investors' interests.

So … when we think about the private equity business model as a whole, without regard to any specific registrant, we see unique and inherent temptations and risks that arise from the ability to control portfolio companies, which are not generally mitigated, and may be exacerbated, by broadly worded disclosures and poor transparency.

Industry Trends

Finally, in OCIE we see some current developments in the industry that appear to be generating pressure on private equity firms and heightening the risk of a misalignment of interests between advisers and investors. Although the capital raising market has substantially improved since the lowest points in 2009 and 2010, there still appears to be a consolidation and shake out in the industry. This has created several issues.

First, we continue to see "zombie" advisers, or managers that are unable to raise additional funds and continue to manage legacy funds long past their expected life. These managers are incentivized to continue to profit from their current portfolio even though that may not be in the best interest of investors. These managers may increase their monitoring fees, shift more expenses to their funds or try to push the envelope in their marketing material by increasing their interim valuations, sometimes inappropriately and without proper disclosure.

Next, consolidation will also produce some winners — advisers that are able to rapidly grow their assets under management — and we are seeing the emergence of larger managers, which have additional and different business lines, products, and stake holders than an adviser that only manages private equity funds. Most of these managers have grown up managing purely private equity vehicles, and some are having difficulty adjusting to the complexities and inherent conflicts of interest of their new business model.

OCIE's experience is that complexity and rapid growth have created governance and compliance issues that should be addressed as these firms mature and evolve.   For example, we have seen that much of the growth in private equity is not coming from the traditional co-mingled vehicles but from separate accounts and side-by-side co-investments. These accounts, which invest alongside the main co-mingled vehicle, are often not allocated broken deal expenses or other costs associated with generating deal flow. This may be occurring because the rapidly growing adviser has not yet updated its policies and procedures to be able to handle separate accounts or because the adviser may not have invested sufficient capital in the back-office to be able to perform a proper allocation. Whatever the reason, it's clear that in many instances these firms' compliance functions are not growing as quickly as their businesses.

Also, despite the relatively successful performance of the private equity industry, we have observed returns begin to compress and converge. As a result, fewer managers will be able to overcome their preferred return and collect carried interest, which heightens the risk that managers may attempt to make up that shortfall in revenue by collecting additional fees or shifting expenses to their funds. As I'll discuss shortly, this has been a significant issue that OCIE has seen in our private equity registrant population.

Examination Observations

With some of these industry dynamics as a backdrop, I'll discuss a few of the observations from the more than 150 exams of private equity advisers that we have conducted to date.

Expenses

By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have

identified what we believe are violations of law or material weaknesses in controls over 50% of the time.

This is a remarkable statistic. Historically, the most frequently cited deficiencies in adviser exams involve inadequate policies and procedures or inadequate disclosure. This makes sense because virtually any primary deficiency can be coupled with a secondary deficiency for failing to maintain policies and procedures to prevent the primary deficiency or failing to disclose the primary deficiency to clients. And the deficiency rate for these two most commonly cited deficiencies usually runs between 40% and 60% of all adviser examinations conducted, depending on the year. So for private equity firms to be cited for deficiencies involving their treatment of fees and expenses more than half the time we look at the area is significant.

Some of the most common deficiencies we see in private equity in the area of fees and expenses occur in firm's use of consultants, also known as "Operating Partners," whom advisers promote as providing their portfolio companies with consulting services or other assistance that the portfolio companies could not independently afford. The Operating Partner model is a fairly new construct in private equity and has arisen out of the need for private equity advisers to generate value through operational improvements. Many limited partners view the existence of Operating Partners as a crucial part of their investment thesis when they allocate to private equity funds, largely because the Operating Partner model has proven to be effective.

Many of these Operating Partners, however, are paid directly by portfolio companies or the funds without sufficient disclosure to investors. This effectively creates an additional "back door" fee that many investors do not expect, especially since Operating Partners often look and act just like other adviser employees. They usually work exclusively for the manager; they have offices at the manager's offices; they invest in the manager's funds on the same terms as other employees; they have the title "partner"; and they appear both on the manager's website and marketing materials as full members of the team. Unlike the other employees of the adviser, however, often they are not paid by the adviser but instead are expensed to either the fund or to the portfolio companies that they advise.

There are at least two problems with this. First, since these professionals are presented as full members of the adviser's team, investors often do not realize that they are paying for them a la carte, in addition to the management fee and carried interest. The adviser is able to generate a significant marketing benefit by presenting high-profile and capable operators as part of its team, but it is the investors who are unknowingly footing the bill for these resources. Second, most limited partnership agreements require that a fee generated by employees or affiliates of the adviser offset the management fee, in whole or in part. Operating Partners, however, are not usually treated as employees or affiliates of the manager, and the fees they receive therefore rarely offset management fees, even though in many cases the Operating Partners walk, talk, act, and look just like employees or affiliates.

Another similar observation is that there appears to be a trend of advisers shifting expenses from themselves to their clients during the middle of a fund's life — without disclosure to limited partners. In some egregious instances, we've observed individuals presented to investors as employees of the adviser during the fundraising stage who have subsequently being terminated and hired back as so-called "consultants" by the funds or portfolio companies. The only client of one of these "consultants" is the fund or portfolio company that he or she covered while employed by the adviser. We've also seen advisers bill their funds separately for various back-office functions that have traditionally been included as a service provided in exchange for the management fee, including compliance, legal, and accounting — without proper disclosure that these costs are being shifted to investors.

More commonly, we see advisers using process automation as a vehicle to shift expenses. For instance, it is becoming commonplace to automate the investor reporting function. Where, in the past, adviser employees compiled portfolio company information and distributed reports, now a

software package captures operating data directly from the portfolio companies and distributes investor reports automatically. There's certainly nothing wrong with this development that makes private equity advisers more efficient. But the costs of this efficiency gain, including the cost of the software and its implementation, are often borne not by the adviser, who is responsible for preparing and delivering the reports, but by investors when the funds are charged, contrary to the reasonable expectation of the limited partners under a fair reading of the limited partnership agreement.

Hidden Fees

The flipside of expense-shifting is charging hidden fees that are not adequately disclosed to investors.

One such fee is the accelerated monitoring fee. Monitoring fees, as most limited partners know, are commonly charged to portfolio companies by advisers in exchange for the adviser providing board and other advisory services during the portfolio company's holding period. What limited partners may not be aware of is that, despite the fact that private equity holding periods are typically around five years, some advisers have caused their portfolio companies to sign monitoring agreements that obligate them to pay monitoring fees for ten years … or longer. Some of these agreements run way past the term of the fund; some self-renew annually; and some have an indefinite term. We see mergers, acquisitions, and IPOs triggering these agreements. At that point, the adviser collects a fee to terminate the monitoring agreement, which the adviser caused the portfolio company to sign in the first place. The termination usually takes the form of the acceleration of all the monitoring fees due for the duration of the contract, discounted at the risk-free rate. As you can imagine, this sort of arrangement has the potential to generate eight-figure, or in rare cases, even higher fees. There is usually no disclosure of this practice at the point when these monitoring agreements are signed, and the disclosure that does exist when the accelerations are triggered is usually too little too late.

There are other troubling practices in the hidden fee arena including:

- Charging undisclosed "administrative" or other fees not contemplated by the limited partnership agreement;
  Exceeding the limits set in the limited partnership agreement around transaction fees or charging transaction fees in cases not contemplated by the limited partnership agreement, such as recapitalizations; and
  Hiring related-party service providers, who deliver services of questionable value.

The Commission's Enforcement Division recently filed a case[3] against a Manhattan-based private equity manager, alleging the misappropriation of more than $9 million from investors in a private equity fund. The investigation is still continuing, but the Enforcement staff obtained an emergency court order to freeze assets and alleged that the manager had schemed with a longtime acquaintance to set up a sham due diligence arrangement. The manager is alleged to have used fund assets to pay fees to a front company controlled by his acquaintance. The fees received by the front company were supposed to be used to conduct due diligence for the fund on potential investments. Instead, the money was allegedly kicked back (indirectly) to the private equity manager, and he is alleged to have spent it for other purposes. For example, he allegedly paid hefty commissions to third parties to secure investments from pension funds. He also allegedly rented luxury office space and used the funds to project the false image that his firm was a thriving international private equity operation.

Marketing and Valuation

The final set of OCIE's observations I want to discuss have to do with marketing and valuation. Since the private equity fundraising market continues to be tight for some advisers, we expect marketing to continue to be a key risk area even as the overall market improves.

Over the past several years, there has been an industry discussion about the relevance of interim valuations. The industry has argued that since management fees are not based on interim valuations, the role of interim valuations is limited. Last year at this conference, Bruce Karpati, then of the SEC's Enforcement Division, addressed this debate, noting the importance of valuations in fund marketing. Academic studies have supported this thesis, showing that some advisers inflate valuations during periods of fundraising.[4] Valuation, of course, is a clear signal to investors about the health of an adviser's most current portfolio, which may be the most relevant to an investor considering whether to invest in a current offering.

A common valuation issue we have seen is advisers using a valuation methodology that is different from the one that has been disclosed to investors. The Division of Enforcement recently settled a case[5] against a New York-based private equity manager based on allegations that he misled investors and potential investors with respect to the value of a fund-of-funds that he managed. Enforcement alleged that the manager disseminated quarterly reports and marketing materials, which wrongly stated that the valuation of the fund-of-fund's holdings was based on values that were received from the portfolio manager of each of the underlying funds. In fact, the manager allegedly valued the fund's largest investment at a significant markup to the underlying manager's estimated value. He also sent marketing materials reporting an internal rate of return that failed to deduct fees and expenses. That one change in valuation methodology caused a huge change in the interim performance of a fund that was still being marketed to prospective investors. As a result of the change in valuation methodology, the fund's reported gross internal rate of return was enhanced — in one quarter, from roughly 3.8% to more than 38%.

Some of you may be under the mistaken impression that when our exams focus on valuation, our aim is to second-guess your assessment of the value of the portfolio companies that your funds own … to challenge that a portfolio company is not worth X, but X minus 3%. We are not, except in instances where the adviser's valuation is clearly erroneous.

Rather, our aim and our exams are much more focused. Because investors and their consultants and attorneys are relying on the valuation methodology that an adviser promises to employ, OCIE examiners are scrutinizing whether the actual valuation process aligns with the process that an adviser has promised to investors. Some things our examiners are watching out for are:

- Cherry-picking comparables or adding back inappropriate items to EBITDA — especially costs that are recurring and persist even after a strategic sale — if there are not rational reasons for the changes, and/or if there are not sufficient disclosures to alert investors.

- Changing the valuation methodology from period to period without additional disclosure — even if such actions fit into a broadly defined valuation policy — unless there's a logical purpose for the change. For instance, we have observed advisers changing from using trailing comparables to using forward comparables, which resulted in higher interim values for certain struggling investments. While making such changes is not wrong in and of itself, the change in valuation methodology should be consistent with the adviser's valuation policy and should be sufficiently disclosed to investors.

In addition to valuation, our examiners are reviewing marketing materials to look for other inconsistencies and misrepresentations. Some areas of particular focus are: performance marketing, where projections might be used in place of actual valuations — without proper disclosure; and misstatements about the investment team. We especially focus on situations where key team members resign or announce a reduced role soon after a fundraising is completed, raising suspicions that the adviser knew such changes were forthcoming but never communicated them to potential investors before closing.

Developing Compliance Programs

Based on these observations, it's fair to say that there's more work to be done in the private equity industry to bring controls and disclosures in line with existing requirements and investor expectations. As compliance professionals, you and your senior leadership are tasked with ensuring that your firm is not only compliant with the technical requirements of the law, but is also treating its clients and investors fairly, equitably, and in accordance with its status as a fiduciary.

I gave a speech a few weeks ago, where I mentioned the three ways where I see registrants encountering problems with the Commission, clients, plaintiffs' attorneys, and sometimes, criminal authorities: outright fraud, reckless behavior, and conflicts of interest. The most effective defense your firms have against such risks is a strong culture of compliance that is supported by the owners and principals of a firm and reinforced through an independent, empowered compliance department.

It all starts at the top. A compliance department has the best chance of success if management is fully supportive of compliance efforts and provides the CCO with the resources needed to do an effective and thorough job. Additionally, strength and effectiveness of a compliance department is boosted when compliance officers not only understand relevant laws and rules, but are integrated into a firm's business. In OCIE, we've seen that compliance officers, who — for example — participate in weekly deal meetings and in meetings with investors, or who review deal memos, tend to be more effective in spotting issues early and are more respected in their organizations. As a result, we generally see their firms tending to be more compliant.

Invariably, compliance issues will arise at your organizations. Whether those issues develop into larger risks to the firm and investors will in large part depend on whether you are not only empowered to spot those issues but also to raise and to assist in resolving them. Ultimately, a healthy compliance program should make your firm and the entire private equity industry more attractive to investors.

Why Is OCIE Focusing on Private Funds?

Before I close, I want to address some questions that I'm often asked: Why is OCIE spending resources on private funds? Investors in hedge funds and private equity funds are "big boys" that can take care of themselves. Why not devote more resources to helping "mom and pop" investors?

I have a few responses.

First, the Private Equity Growth Capital Council ("PEGCC") itself has identified the number one myth about private equity as the myth that private equity only benefits wealthy investors.[6] "Mom and pop" are much more invested in these funds than people realize. PEGCC states it best: "Private equity investment provides financial security for millions of Americans from all walks of life. The biggest investors in private equity include public and private pension funds, endowments and foundations, which account for 64% of all investment in private equity in 2012." To the extent private equity advisers are engaged in improper conduct, it adversely affects the retirement savings of teachers, firemen, police officers, and other workers across the U.S.

Next, the results of our exams indicate that because of the structure of the industry, the opaqueness of the private equity model, the broadness of limited partnership agreements, and the limited information rights of investors, we are perceiving violations despite the best efforts of investors to monitor their investments. They often have little to no chance of detecting the kinds of issues I discussed today on their own. So, if we're not on the job, doing exams in this area and spreading sunshine, these problems — which involve significant sums of money — are more likely to persist.

Conclusion

In conclusion, we hope that sharing our exam observations of private equity advisers is helpful to investors and enables them to ask more and better questions before investing and after investments are made, and, in particular, to request more and better disclosure about the fees and expenses that they will pay in addition to the management fee and carried interest.

We also hope that our observations are helpful to the private equity industry. Consider it OCIE hopping down off the beach stand, wading waist-deep into the water, and offering that we see unique risks — riptides and jetties — inherent in your business model. Based on our observations of the controls and disclosures currently in place to mitigate these risks, we advise that you work to strengthen your strokes and pay greater attention and give wider berth, to the potential problems that could harm your clients and your businesses, as well as the private equity industry as a whole.

I believe that if we each do our part to develop an effective regulatory scheme and compliance standard that protects investors and the U.S. financial markets — and also works with your business model — you will see that the additional confidence will allow you to access new markets and to continue to grow the private equity industry, which is a crucial part of the American and global economy.

Thank you.

Footnotes

[1] I would also like to thank the OCIE examiners who so diligently and energetically conducted the exams that form the basis of this talk and especially my colleagues, Elizabeth Blase and Igor Rozenblit, for their substantial and cheerful assistance in preparing these remarks.

[2] 2014 Preqin Global Private Equity Report, at 6, available at: https://www.preqin.com/item/2014-preqin-global-private-equity-report/1/8194.

[3] SEC v. Lawrence E. Penn, III, Michael St. Altura Ewers, Camelot Acquisitions Secondary Opportunities Management, LLC, the Camelot Group International, LLC and Ssecurion LLC, (Jan. 30, 3014). Press release and complaint available at: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540703682.

[4] See, e.g., Tim Jenkinson, Miguel Sousa, and Rüdiger Stucke, "How Fair are the Valuations of Private Equity Funds?" (Feb. 27, 2013); see also Barber and Yasuda, "Interim Fund Performance and Fundraising in Private Equity" (Nov. 18, 2013).

[5] In the Matter of Brian Williamson, File No. 3-15430 (Jan. 22, 2014), available at: http://www.sec.gov/litigation/admin/2014/33-9515.pdf.

[6] Private Equity Growth Capital Council, "Fact and Fiction," available at: http://www.pegcc.org/education/fact-and-fiction/.

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