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DISCLOSURE

Disciplined Compliance With Investor Disclosures Protects Funds From SEC Enforcement

BY JOHN CANNON AND KATHLEEN MARCUS

Following more than two years of private fund advisor "presence exams," disclosure deficiencies remain the hallmark of most enforcement actions. Nonetheless, the precision of the disclosures demanded by the Securities and Exchange Commission ("SEC") Staff has caught even well-intentioned managers off guard. To avoid the SEC crosshairs, fund managers must exhibit substantial discipline, particularly in the areas of: (i) disclosed valuation methodology (i.e., inconsistencies between disclosed and utilized valuation methodologies and the use of selective data to influence valuations); (ii) inaccuracies in marketing materials; (iii) omissions and errors in disclosing the accounting or allocation of fees and costs; and (vi) the adoption and implementation of regulatory compliance policies and procedures. It is important to note that best intentions and improved accuracy or even the financial success of a fund will not deter an enforcement action if disclosures are incomplete, inconsistent, outdated or contain errors.

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Exactitude Required in Valuation Methodology Disclosures

In a speech titled "Spreading Sunshine in Private Equity," former Office of Compliance Inspections and Examinations ("OCIE") Director Andrew Bowden emphasized that SEC examiners are specifically looking for: (1) whether firms are "cherry-picking comparables" or adding inappropriate items to their earnings without sufficient disclosure; and (2) whether firms are changing their valuation methodology without additional disclosure.[1] He added, "While making such changes [to the valuation methodology] 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."[2]

To this end, the SEC has pursued enforcement actions where valuation methods utilized by the fund deviated from the methods the disclosed in marketing materials, Private Placement Memoranda ("PPM"), diligence, or otherwise, even when the valuation reached was arguably *accurate*. Even for the most well-intentioned fund, this creates an enforcement risk related to disclosures that have not been tailored or updated to precisely match current methods or practices.

For example, in *In the Matter of Oppenheimer Asset Management Inc., et al.* (2013),[3] the SEC charged two investment advisers managing a private equity fund for using "par value" to value assets rather than the "underlying managers' estimated values"[4] as disclosed in marketing materials and quarterly reports. Although the SEC did not suggest that the use of "par value" was inherently improper, it argued that the defendants'

[1] Andrew J. Bowden, Director, OCIE, Sec. & Exch. Comm'n, Spreading Sunshine in Private Equity (May 6, 2014).

[2] *Id.*

[3] *In the Matter of Oppenheimer Asset Management Inc., et al.*, File No. 3-15238 (Mar. 11, 2013), *available at:* https://www.sec.gov/litigation/admin/2013/33-9390.pdf.

[4] The "underlying managers" were the managers of the real estate funds that the private equity fund had invested in.

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change in methodology lacked proper disclosure. The defendants settled the charges, agreeing to pay approximately $2.8 million in disgorgement of fees to investors.

Similarly, in 2012, the SEC charged a hedge fund advisory firm and its executives for touting the use of ''current, fair and accurate market valuations,'' when, according to the SEC, the firm valued the vast majority of their investments at face value. *See SEC v. Yorkville Advisors* (2012).[5] The SEC has even pursued enforcement actions when a fund expressly disclosed that it may utilize *discretion* in its valuations but then failed to properly document such instances. *See In the Matter of Agamas Capital Management, LP* (2013).[6]

Accordingly, firms and practitioners should recognize that the SEC is not searching for a ''better'' or more accurate valuation for the investor; rather, the SEC's focus is whether a fund remained consistent with its disclosures and whether the fund is utilizing a valuation method exactly as promised to investors. The SEC's Enforcement actions highlight the importance of a firm's *continual* assessment of the accuracy of its disclosures pertaining to valuation methodology for each and every quarter.

Use Caution When Touting Talent in Marketing Materials

In his ''Spreading Sunshine'' speech, former Director of OCIE Andrew Bowden noted that the SEC is ''especially focus[ed] on situations where key team members resign or announce a reduced role soon after a fund-raising is completed, raising suspicions that the adviser knew such changes were forthcoming but never communicated them to potential investors before closing.''[7] Mr. Bowden also took issue with team members who transitioned from a manager working for the general partner to a so-called ''operating partner.''[8] Unlike a general partner who is compensated from the management fees, an operating partner is paid from fund assets. The SEC appears to be particularly critical of circumstances where a manager is moved from the general partner's payroll and put on the fund's payroll as a consultant without any significant change in the individual's responsibilities. If contemplating such a transfer, funds should consider the sufficiency of disclosures and the implication of conflict of interest issues.

Anticipate a Review of Allocation and Accounting for Fees and Costs

The SEC has labeled undisclosed expense and hidden fees, such as unidentified consultant salaries, as excess management fees.[9] The SEC has also taken issue with improper charges for undisclosed administrative fees or other fees not contemplated in the LLC or LLP operating agreement, transaction fees in excess of the fees contemplated by the agreement, the automation of management functions,[10] and the hiring of related-party service providers with deliverables of questionable value.[11] In essence, the SEC believes that, without contrary disclosure, the fund's limited partners have a ''reasonable expectation'' that expenses for traditional management functions will be paid for by management and not by the fund.

Additionally, in a widely publicized June 29, 2015 settlement with Kohlberg Kravis Roberts & Co. L.P. (''KKR''), the SEC took a novel aim at fees by scrutinizing the allocation of ''broken deal'' expenses.[12] Specifically, following an examination of KKR, the SEC alleged that more than $17 million in expenses were allocated to its main private equity funds, and not to co-investors, in breach of its fiduciary duty. Importantly, the SEC alleged that neither the limited partnership agreement nor the related offering materials for the funds expressly disclosed that KKR did not allocate broken deal expenses to its co-investors. The matter resulted in a $30 million settlement, including a $10 million penalty.

SEC Examiners actively trace fees and costs to the relevant disclosures and make enforcement referrals when disclosures are deemed insufficient. Notably, where the SEC identified problems with the allocation of fees and costs, the funds often could have insulated themselves from an enforcement action with enhanced, transparent disclosures. A well-drafted agreement and thorough and thoughtful marketing materials and disclosures can avoid these pitfalls.

The Importance of Internal Controls and Compliance

In many of the above investigations and cases, the SEC took issue with the fund's internal controls, including compliance policies and procedures. Indeed, the securities laws offer multiple causes of action by which the SEC can pursue firms for failing to maintain sufficient internal controls. In the context of fund valuations, the SEC has asserted some of these causes of action—most notably, Rule 206(4)-7—when it finds that a firm's internal controls provide insufficient oversight to ensure that its disclosed valuation methodology is being followed.

In the *Oppenheimer* enforcement action, the SEC alleged that the defendants violated Rule 206(4)-7[13] when they failed to adopt and implement written policies reasonably designed to ensure that the valuations provided to investors were consistent with the valuation methods they disclosed in marketing materials. Similarly, in the *KKR* matter, the SEC sanctioned KKR for failing to adopt and implement a written compliance policy or procedure governing its fund expense allocation prac-

[5] *SEC v. Yorkville Advisors, LLC*, No. 12 Civ 7728 (S.D.N.Y. 2012), complaint *available at*: http://www.sec.gov/litigation/complaints/2012/comp22510.pdf.

[6] *In the Matter of Agamas Capital Management, LP*, File No. 3-15616 (Nov. 19, 2013), *available at*: http://www.sec.gov/litigation/admin/2013/ia-3719.pdf.

[7] Bowden, *supra* note 1.

[8] *Id.*

[9] *Id.*

[10] The SEC has observed that traditional management tasks, such as investor reporting, may be shifted to software programs.

[11] *Id.*

[12] Press Release, Sec. & Exch. Comm'n, SEC Charges KKR with Misallocating Broken Deal Expenses (June 29, 2015), http://www.sec.gov/news/pressrelease/2015-131.html.

[13] Rule 206(4)-7 requires implementation of written policies and procedures reasonably designed to prevent violations of the Advisers Act.

tices in a timely matter, even though KKR had made improvements to its procedures. Relatedly, in *In the Matter of GLG Partners, Inc., et al.* (2013),[14] the SEC charged a hedge fund with internal controls failures even though the fund properly valued the investment pursuant to its disclosed valuation policies. According to the SEC, hedge fund employees received information calling into question the valuation on numerous occasions, and the fund had inadequate policies and procedures to ensure that such information was communicated to the fund's pricing committee.

Well Designed Procedures Can Mitigate SEC Risk Areas

Regulation by disclosure is particularly challenging for funds. Public companies may make disclosures at any time, and upon receiving the information, their investors are free to sell shares in a liquid market. To the contrary, fund investors often commit capital for years and cannot readily sell or transfer their interests upon receipt of new information. Accordingly, great care must be used when drafting the initial offering materials to provide wide latitude for fund managers to make the best valuation and staffing decisions throughout the life of the fund without running afoul of the existing disclosures. It is equally important for funds to *follow* stated valuation methods and disclose improvements in valuation techniques, data, and any changes in accounting for costs and fees. Justification for any deviations over time must be well documented, and where possible, disclosed to investors. Moreover, the SEC expects that funds will adopt policies and procedures that contain more than principled statements regarding ethics and governance. Compliance procedures must be tailored to the fund's operations and provide express directives to ensure proper accounting, disclosure protocols, governance structure, and ensure accurate information disclosure.

Although the two year presence exam period has concluded, the OCIE cited a high rate of deficiencies and stated its intention to continue with compliance examinations.[15] In this new era, well-intentioned managers must not only work to achieve the best solution or provide the greatest accuracy for their investors, but they must also be ready to communicate with investors as necessary or work within their historic disclosures to avoid SEC scrutiny.

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[14] *In the Matter of GLG Partners, Inc., et al.*, File No. 3-15641 (Dec. 12, 2013), *available at:* https://www.sec.gov/litigation/admin/2013/34-71050.pdf.

[15] During the presence exam initiative, examiners identified ''violations of law or material weaknesses in controls over 50% of the time.'' Bowden, *supra* note 1.