# Avoiding the SEC's Crosshairs

## Advice for hedge funds and private equity funds

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"The SEC is first and foremost a disclosure agency."[1] Predictably, the SEC has carried this mantra into its expanded mission to more aggressively police private equity funds and hedge funds. The precision of the disclosures demanded by the SEC Staff, however, has caught even well-intentioned managers off guard. Best intentions, improved accuracy or even the financial success of a fund will not deter an enforcement action if disclosures are incomplete, outdated or contain errors.

Fortunately, funds now have increased visibility into where and how the SEC Staff will most actively scrutinize statements to investors. Following two years of "presence exams"[2] by the SEC's Office of Compliance Inspections and Examinations (OCIE), targeted speeches by the Commission, and an increase in investigations and enforcement actions, several topic areas have emerged as regulatory "hot spots." These topics include: (i) 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.

One thing is clear: operating under the SEC's disclosure-based regime requires substantial discipline from fund managers on an ongoing basis. Carefully drafted initial disclosures coupled with thoughtfully targeted compliance efforts, using the lessons from the cases and investigations set forth below, may significantly reduce risk of an enforcement referral following a visit by SEC Examiners.

### Valuation cases and investigations emphasize exactitude in methodology disclosures

Unlike a public company with an available market and liquidation value, the valuation of a private entity requires intensive analysis. Because a reasonable valuation for a private entity may be reached through a variety of widely accepted methods, the SEC is hesitant to substitute its own valuation judgments for a fund's calculations. Instead, the SEC looks to the details of fund disclosures to assess whether a particular description properly informed investors regarding the methodologies used to reach a valuation.

In a speech titled "Spreading Sunshine in Private Equity," former OCIE Director Andrew Bowden[3] 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.[4] He added, "While making such changes [to 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."[5]

To this end, the SEC has pursued enforcement actions where valuation practices utilized by the fund deviated from the methods the fund represented to investors it would apply 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. The SEC treats such instances as disclosure violations actionable under traditional anti-fraud statutes used to police securities disclosures, most commonly Section 10(b) of the Exchange Act and Rule 10b-5. The SEC also frequently brings claims under Sections 206 of the Investment Advisers Act of 1940 (Advisers Act). Sections 206(1) and (2) prohibit investment advisers from defrauding "any client or prospective client." Section 206(4) more broadly forbids investment advisers from any fraudulent act or practice, as further defined by rules and regulations promulgated thereunder.[6]

Recent enforcement actions based on disclosure lapses are telling. For example, in *In the Matter of Oppenheimer Asset Management Inc.,* et al. (2013),[7] the SEC charged two investment advisers managing a private equity fund with misstating the value of its investments and misrepresenting its valuation method to potential investors. In marketing materials and quarterly reports given to investors, the defendants stated that the fund's asset values were "based on the underlying managers' estimated values."[8] However, contrary to this stated policy—which had been approved by the defendants' compliance department—the portfolio manager for the fund allegedly began valuing the fund's largest investment at "par value," resulting in a significant markup of the investment. Although the SEC did not suggest that the valuation methodology based on "par value" was inherently improper, it argued that the defendants' change in methodology without proper disclosure was a violation of Section 17(a) of the Securities Act and of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The defendants settled the charges, agreeing to pay approximately $2.8 million in disgorgement of fees to investors.[9]

Similarly, in 2012, the SEC charged a hedge fund advisory firm and two of its executives for touting a robust valuation procedure that valued investments at "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).[10] The firm also allegedly failed to observe other requirements set forth in its disclosed policies, such as regular valuation committee meetings and provided misleading information concerning its valuations to auditors. The SEC argued that the failure to adhere to the firm's stated valuation method was a fraudulent scheme in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.[11] The complaint sought a permanent injunction, disgorgement of unearned gains, and civil monetary penalties. Litigation is still ongoing in the Southern District of New York.[12]

Notably, the SEC has pursued enforcement actions even when a fund expressly disclosed that it may utilize discretion in its valuations. Specifically, in *In the Matter of Agamas Capital Management, LP* (2013),[13] a hedge fund's valuation policy, detailed in its private placement memorandum, allowed the defendant to use good faith discretion in certain circumstances, but required documentation of its basis for such a discretionary valuation. According to the SEC, the fund deviated from its stated valuation procedures by failing to fully document its repeated use of discretion in valuing its securities. The SEC brought claims against the hedge fund manager for violations of Section 206(4) of the Advisers Act and of Rule 206(4)-7 thereunder for failing to implement procedures designed to prevent improper valuation of its assets and inaccurate disclosures to investors. In its settlement, the manager agreed to pay $250,000 in civil penalties.

These cases highlight the importance of a firm's continual assessment of the accuracy of its disclosures pertaining to valuation methodology for each and every quarter. In addition to confirming that valuations were calculated pursuant to the disclosed methodology, the stated practices and processes (e.g., meetings, file documentation) for calculating a valuation range must be followed carefully. 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 stayed consistent with its disclosures and whether the fund is utilizing a valuation method exactly as promised to investors.

### Marketing based violations: Talent and ongoing responsibilities are material

In his "Spreading Sunshine" speech, former Director of OCIE Andrew Bowden noted that, in its investigation of marketing materials and valuation disclosures, the SEC is "especially focus[ed] 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."[14] This disclosure omission is relatively straightforward: key talent and team members are a material reason that investors chose one private equity fund over another. Nondisclosure of the fact that those team members plan on leaving or will have reduced responsibilities in the future can violate securities laws.

Additionally, the former Director of OCIE also took issue with circumstances where a team member is transitioned from a manager working for the general partner to a so-called "operating partner."[15] Whereas a manager is paid by the general partner, and thus paid from the general partner's management fees, an operating partner is hired as a consultant to the fund and paid out of the fund's assets. Utilizing operating partners as consultants is not unlawful by itself. However, 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 real change in the individual's responsibilities. Such a transfer can implicate disclosure and conflict of interest issues. On the cost side, the SEC expects complete transparency about which costs are incurred by the fund and which are allocated to management. On the conflict side, management's interest in balancing its yearly operating budget and increasing its take-home fees can be potentially antagonistic to the investor's interest in the long-term growth of investments.

In sum, disclosures (or nondisclosures) relating to the roles of key employees, payroll allocation, and potential conflicts of interest will likely be reflected in the same marketing materials and company records as those that are pertinent to a valuation investigation.

## SEC closely reviews how funds disclose allocation and accounting for fees and costs

The SEC has taken aim at what it terms excess management fees.[16] The most common components of such excess fees are undisclosed expenses and hidden fees. As described above, one of the largest undisclosed expenses is consultant salaries. The SEC has also observed 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, and the hiring of related-party service providers with deliverables of questionable value.[17]

Automation of management functions has also caught the attention of regulators. The SEC has observed that traditional management tasks, such as investor reporting, may be shifted to software programs. Once again, the SEC does not take issue with the business decision to implement automation. Rather, the SEC has questioned whether an expense for what is traditionally a management task is being covertly passed on to the fund. 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.

Finally, in the widely publicized June 29, 2015 settlement with Kohlberg Kravis Roberts & Co. L.P. (KKR), the SEC took aim at fees.[18] Specifically, following an examination of KKR which commenced in 2013, the SEC alleged that more than $17 million in expenses were allocated to its main private equity funds in breach of its fiduciary duty. KKR agreed to pay nearly $30 million to settle the charges, including a $10 million penalty.

The SEC alleged that from 2006 to 2011, KKR allocated 80% of $338 million in what the SEC characterized as broken deal expenses related to unsuccessful buyout opportunities to its flagship private equity funds (and, indirectly, the limited partners in those funds, including many pension funds and other large institutional investors). During the same period, except for a partial allocation to certain co-investors in 2011, KKR allegedly did not allocate broken deal expenses to KKR's co-investors (including dedicated co-investment vehicles for its executives, certain consultants and other co-investors), even though KKR's co-investors had allegedly participated in and benefitted from KKR's sourcing of transactions (investing $4.6 billion alongside the $30.2 billion invested by KKR's flagship private equity funds). 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.

In another recent announcement, three private equity fund advisers within The Blackstone Group agreed to pay nearly $39 million to settle charges that they failed to fully inform investors about benefits that the advisers obtained from accelerated monitoring fees and discounts on legal fees.[19] Blackstone Management Partners, Blackstone Management Partners III, and Blackstone Management Partners IV allegedly failed to adequately disclose the acceleration of monitoring fees paid by fund-owned portfolio companies prior to the companies' sale or initial public offering. The payments to Blackstone, the Commission alleged, reduced the value of the portfolio companies prior to sale, to the detriment of the funds and their investors. The SEC also alleged that fund investors were not informed about a separate fee arrangement that provided Blackstone with a larger discount on services by an outside law firm than the discount that the law firm provided to the funds.

These matters demonstrate that SEC Examiners actively trace fees and costs to the relevant disclosures and make enforcement referrals when disclosures are deemed insufficient. Where the SEC has identified problems with the allocation of fees and costs, in each instance, the funds could have insulated themselves from enforcement action with enhanced, transparent disclosures. A well-drafted agreement and thorough and thoughtful marketing materials and disclosures can avoid these pitfalls.

## Necessity for attention to internal controls, compliance policies and procedures

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, for instance, the SEC alleged that the defendants violated Rule 206(4)-7[20] 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 contended that KKR did not adopt and implement a written compliance policy or procedure governing its fund expense allocation practices in a timely matter. The SEC took this position even though KKR had improved its procedures over time (e.g., in 2011, KKR revised its practices and allocated some share of broken deal expenses to several committed capital co-investment vehicles, and in 2012, KKR further revised its methodology and began to allocate a share of those expenses to its co-investors). The SEC considered the failure to timely adopt such a policy to be a violation of Section 206(4) of the Advisers Act and Rule 206(4)-7.

Relatedly, in *In the Matter of GLG Partners, Inc.*, et al. (2013),[21] 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. The SEC believed this compliance failure allowed for an overvaluation of assets and nearly $8 million in unearned management fees. The SEC alleged that the hedge fund violated Sections 13(b)(2)(A) and (B) of the Exchange Act, which require public companies to devise and maintain sufficient internal accounting controls and bookkeeping to maintain accountability for its assets.[22] The hedge fund settled the claims, agreeing to disgorge approximately $9 million of its unearned management and administrative fees plus prejudgment interest.

## Design procedures that navigate SEC risk areas

Although the two year presence exam period has concluded, the OCIE noted a high rate of deficiencies it found during this initiative.[22] Accordingly, the OCIE has stated its intention to continue to concentrate resources on compliance examinations of private equity and hedge funds. Fortunately, the last few years have begun to illuminate a pathway for the industry.

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.

Recent SEC precedent clearly provides that funds must meticulously disclose and follow stated valuation methodologies. Improvements in valuation techniques or data, as well as accounting for costs and fees, must be considered carefully in the context of the fund's disclosures. Justification for any changes 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. For example, 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. In this new era, well-intentioned managers must not only work to achieve the best solution or provide the greatest accuracy, but they must also work within their historic disclosures to avoid SEC scrutiny. THFJ

## NOTES

[1] Daniel M. Gallagher, Commissioner, Sec. & Exch. Comm'n, Remarks at Society of Corporate Secretaries & Governance Professionals (11 July 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539700301. Furthermore, as noted on the Commission's website: "all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it." The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (modified 10 June 2013).
[2] In 2012, the Office of Compliance Inspections and Examinations (OCIE) announced an initiative to conduct focused, risk-based examinations (labeled "presence exams") of investment advisors to private funds that recently registered with the Commission.
[3] In April 2015, the SEC announced that Andrew Bowden would be leaving the agency at the end of the month to return to the private sector. Press Release, Sec. & Exch. Comm'n, OCIE Director Andrew Bowden to Leave SEC (7 April 2015), http://www.sec.gov/news/pressrelease/2015-59.html.
[4] Andrew J. Bowden, Director, OCIE, Sec. & Exch. Comm'n, Spreading Sunshine in Private Equity (6 May 2014).
[5] Id.
[6] A further discussion of the relevant statutes and causes of action is provided below.
[7] In the Matter of Oppenheimer Asset Management Inc., et. al., File No. 3-15238 (11 March 2013), available at: https://www.sec.gov/litigation/admin/2013/33-9390.pdf.
[8] The "underlying managers" were the managers of the real estate funds that the private equity fund had invested in.
[9] Notably, in a separate action, the SEC also charged the former portfolio manager of the fund with misleading investors about the valuation and performance of the fund's investments through marketing materials and other communications. In its settlement, the SEC barred the portfolio manager from the securities industry and ordered him to pay $100,000 in civil penalties.
[10] 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.
[11] The SEC also claimed that the defendants were investment advisers defrauding the clients – the hedge funds – in violation of Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-8 thereunder.
[12] All of the SEC's claims survived the defendants' motion to dismiss in the district court for the Southern District of New York. SEC v. Yorkville Advisors, LLC, No. 12 Civ. 7728 (GBD), 2013 U.S. Dist. LEXIS 110624, at *14 (S.D.N.Y. Aug. 1, 2013). The defendants raised several defenses: (1) the valuations were neither objectively false nor disbelieved when communicated; (2) the valuations were not material; (3) the valuations were not made with the requisite scienter. Although the court rejected these arguments, it found the SEC's allegations "minimally sufficient" in stating a violation after the SEC failed to demonstrate with facts that the overvaluations were material or made with scienter or negligence. Id. at *11-12.
[13] In the Matter of Agamas Capital Management, LP, File No. 3-15616 (19 November 2013), available at: http://www.sec.gov/litigation/admin/2013/ia-3719.pdf.
[14] Bowden, supra note 4.
[15] Id.
[16] Id.
[17] Press Release, Sec. & Exch. Comm'n, SEC Charges KKR with Misallocating Broken Deal Expenses (29 June 2015), http://www.sec.gov/news/pressrelease/2015-131.html.
[18] In the Matter of Blackstone Management Partners, L.L.C., File No. 3-16887 (7 October 2015), available at: http://www.sec.gov/litigation/admin/2015/ia-4219.pdf ; see also Press Release, Sec. & Exch. Comm'n, Blackstone Charged with Disclosure Failures (Oct. 7, 2015), http://www.sec.gov/news/pressrelease/2015-235.html.
[19] Rule 206(4)-7 requires implementation of written policies and procedures reasonably designed to prevent violations of the Advisers Act.
[20] In the Matter of GLG Partners, Inc., et al., File No. 3-15641 (12 December 2013), available at: https://www.sec.gov/litigation/admin/2013/34-71050.pdf.
[21] The SEC also brought claims under Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13, and 12b-20 thereunder which list filing requirements for issuers of registered securities.
[22] During the presence exam initiative, examiners identified "violations of law or material weaknesses in controls over 50% of the time." Bowden, supra note 4.