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SEC Speech Sheds Light on Upcoming Private Equity Enforcement Focus

On May 13, 2015, Marc Wyatt, acting director of the Security and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE"), addressed the Private Equity International Private Fund Compliance Forum.[1] Wyatt's speech follows nearly a year after a similar speech by former OCIE Director Andrew Bowden, which outlined the SEC's intent to aggressively monitor and encourage transparency in the private equity industry.[2] Wyatt acknowledges some changes in the private equity industry, but he also highlights several areas of focus for OCIE in the years to come. Wyatt stressed three areas in particular for OCIE enforcement going forward: improper expenses and expense allocation, co-investment allocation and conflicts of interest, and real estate advisers.

Background

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") subjected previously exempt hedge fund managers, private equity fund managers, and real estate fund managers to SEC oversight. In 2012, the SEC introduced the Presence Exam Initiative ("PEI"), which assessed the issues and risks posed by the private equity industry. Between October 2012 and May 2014, the PEI examined over 150 private equity advisers. Through the PEI, the OCIE flagged several areas for strict monitoring going forward in the private equity industry. These areas included improper expenses, hidden fees, and issues in the marketing and valuation of private equity funds.

Development in the Private Equity Industry

Wyatt notes several areas of development in the private equity industry over the last year, including industry growth, enhanced contact with fund managers and investors, and greater participation by institutional investors. Examples of these developments include:

- Private equity has grown by 25% between year-end 2011 through Q2 2014. Capital raised by private equity firms has increased over 40% (from $354 billion in Q1 2012 to $503 billion in Q3 2014). A decrease in the size of currently marketed funds (from $410 million in January 2012 to $355 million in September 2014) suggests the formation of smaller fund managers.

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Simultaneously, an increase in the size of actual funds raised (from $316 million in the 12 months ending March 2012 to $497 million in the 12 months ending Q4 2014) points toward "the natural maturing and consolidation of the industry," particularly attractive in terms of drawing large, non-U.S. investors.

- OCIE has increased its expertise in the private equity field, particularly in its creation of the specialized Private Funds Unit ("PFU"). Comprised of experienced OCIE examiners and led by Igor Rozenblit, a private equity industry veteran, the PFU is dedicated to examining private fund advisers, including private equity advisers. The PFU allows OCIE to form and maintain relationships with major figures in the private equity industry, and further its expertise in the private equity industry.
- Press and media attention to improper private equity fee and expense practices has opened dialogue between investors and fund managers.[3] Increased investor awareness of fees and expenses following Director Bowden's 2014 speech has led some managers to change their disclosure practices in partnership agreements. Many private equity funds now disclose general and operating partner roles, as well as fee and expense practices on firm websites. Furthermore, many advisers are now retaining consultants to evaluate and revise their current fee practices.

Areas for Improvement

Although Wyatt notes these changes in the private equity industry over the last year, he also highlights several ongoing problems in the industry. In particular, Wyatt calls for continued OCIE enforcement against improper expenses and expense allocation, as well as increased attention to co-investment allocation. Wyatt also indicates that OCIE will pay increased attention to vertically integrated private equity real estate advisers.

1. **Improper Expenses and Expense Allocation.** Moving forward, OCIE will continue to focus on improper expenses and expense allocation by private equity managers. Although the industry has improved, Wyatt remarks, "Many managers still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty." Expense shifting from parallel funds—funds for insiders, friends, family or preferred investors—to the main comingled flagship vehicles remains difficult for investors to detect. However, Wyatt notes that this sort of practice is "easy for [OCIE] examiners to detect." Going forward, managers and investors

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can expect greater OCIE oversight and enforcement of misapplied fees and misallocated expenses, especially expense shifting.

2. **Co-Investment Allocation and Conflicts of Interest.** OCIE will also closely monitor co-investment allocation, particularly proper disclosure of co-investment rights to potential investors. Examiners have found several instances where investors were unaware that another investor had negotiated priority co-investment rights. Aside from the significant economic value of some co-investment rights, undisclosed co-investors can be a source of potential conflicts of interest. Wyatt points out, "[A]llocating co-investment opportunities in a manner that is contrary to what you [managers] have promised your investors can be a material conflict and can result in violations of federal securities laws and regulations." Wyatt recommends fund managers "have a robust and detailed co-investment allocation policy which is shared with all investors," rather than sweeping potential conflicts under the rug. Similar to fees and expenses, it seems that OCIE will encourage full disclosure of co-investment opportunities and potential conflicts of interest by fund managers to investors.
3. **Real Estate Advisers.** In addition to traditional private equity, OCIE's PFU reviewed private equity real estate advisers and has decided to examine disclosure of fees and expenses relating to property and asset management. After purchasing a property, these real estate managers often offer property management, construction management and leasing services for additional fees "at or below market rate." PFU exams revealed that some managers rely on informal or no data to support these fees. Wyatt warned that private equity real estate managers who provide such services "review their benchmarking practices to ensure they can support their claims."

Wyatt's speech offers insight into the direction OCIE enforcement will take in the coming years. Investors can expect help from OCIE in discovering improper expense shifting and even more push for increased transparency in the industry. If nothing else, Wyatt's speech and recent SEC activity indicate that the SEC remains interested and engaged on the subject of fees and expenses, and will continue to enforce proper allocation of fees and expenses in private equity.

To discuss Acting Director Wyatt's recent speech and its implications, please contact your Reinhart attorney or any member of Reinhart's Institutional Investor Services team.

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[1] Marc Wyatt, Acting Director, Office of Compliance Inspections and Examinations, Speech: "Private Equity: A Look Back and a Glimpse Ahead," *Private Equity International ("PEI") Private Fund Compliance Forum 2015* (May 13, 2015).

[2] Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Speech: "Spreading Sunshine in Private Equity," *PEI Private Fund Compliance Forum 2014* (May 6, 2014).

[3] For example, the *New York Times* reported in a June 13, 2015 story by Gretchen Morgenson that private equity managers have been given fee discounts by law firms, accountants and other vendors when the manager's fund portfolio companies and investors are charged higher rates by the same firms. As a law firm that represents institutional investors but not institutional fund managers, Reinhart Boerner Van Deuren s.c. does not have the conflicts of interest associated with such arrangements.

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