SKRC

COMPLIANCE ALERT

JUNE 2017

Certain Key Compliance Topics for Private Equity Fund Advisers

Given the steady stream of regulatory enforcement actions that have targeted private equity fund advisers, the compliance programs of private equity fund advisers continue to be a matter of focus for both regulators and investors. This SKRC Compliance Alert highlights certain compliance topics for private equity fund advisers that have received particular attention.

Expense Allocations

One of the most commonly identified compliance issues of private equity fund advisers is the allocation of expenses. Advisers must ensure that their expense allocation practices are adequately disclosed and consistently applied throughout the life of the fund. For example, traditionally back office functions of advisers, including compliance, legal and accounting, should not be charged to investors unless expressly disclosed. Moreover, absent additional disclosure, automation of these functions should not shift the expenses from advisers to their funds. Another area of concern is the misallocation of expenses, including in particular broken deal expenses, among main flagship funds, parallel funds and co-investment vehicles.

Operating Partners

Of interest to regulators is the use of consultants known as "operating partners," who provide advice and assistance to portfolio companies. While many operating partners function much like employees of an adviser, often working in the adviser's offices and presented in the adviser's marketing materials as "partners," they are paid directly by portfolio companies or the funds, rather than the adviser. Advisers must ensure that this practice is specifically disclosed to investors.

Hidden Fees

The SEC has brought enforcement actions against private equity fund advisers for failing to disclose "hidden fees," such as monitoring fees. Under these arrangements, advisers cause their portfolio companies to enter into long term monitoring agreements that pay the adviser annual monitoring fees for consulting and advisory services. Upon the portfolio company's merger, acquisition, IPO or other triggering event, the monitoring agreements terminate and future monitoring fees under the contract are accelerated and collected by the adviser. The SEC has found that these monitoring arrangements, and the circumstances under which monitoring fees may be accelerated, were not adequately disclosed. Other undisclosed fees include administrative fees and fees paid to related-party service providers.

Valuation

Focus has been placed on the valuation practices of private equity fund advisers. The valuation methodology used by advisers must be consistent with the one disclosed to investors. Changes in valuation methodology from period to period without additional disclosure, and practices such as the use of third party valuation providers, use of interim valuations in marketing and cherry-picking of valuation comparables have also been scrutinized. Moreover, the SEC recently settled charges against an investment adviser for failing to take into account relevant inputs when pricing client securities, including the prices of the adviser's own trades in the securities.

Allocation of Investments and Co-Investments

Advisers managing multiple funds with similar strategies have a duty to fairly allocate investment opportunities among the funds. Conflicts of interest exist when the funds differ in the amount of fees paid to the adviser and the level of investment by the adviser and its related persons. Similarly, it is important for advisers to establish policies and procedures regarding the allocation of co-investment opportunities to investors. Co-investment allocation practices must be consistent with what has been promised to investors and the adviser's duties to all of its clients.

Unregistered Broker-Dealer Activity

Certain activities of private equity fund advisers may give rise to a requirement to register as a broker-dealer. A private equity fund adviser was recently alleged by the SEC to have provided brokerage services to, and received transaction-based compensation from, its portfolio companies. These brokerage services included soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing transactions. The SEC concluded that this activity caused the adviser to be acting as a broker. The adviser, however, had never been registered with the SEC as a broker or affiliated with a registered broker.

SKRC Observations

While the above and other compliance issues of private equity fund advisers remain in focus, they can be managed through well-considered, practical policies and procedures that are consistently applied, and full and fair disclosure to investors. SKRC provides comprehensive compliance consulting services to assist private equity fund advisers with their myriad compliance obligations.

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