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The SEC's Private Equity Enforcement Concerns

On January 23, 2013, Bruce Karpati, Chief of the Asset Management Unit (the "AMU") of the Enforcement Division of the Securities and Exchange Commission, addressed the Private Equity International Conference in New York. Mr. Karpati discussed certain issues and practices in the private equity industry that are of particular concern to the AMU.[1]

Mr. Karpati described the additional staff with private equity experience the AMU has hired and stated that, as a result of significant growth in private equity before the financial crisis and the recent registration of many private equity fund managers, the number of cases involving private equity may increase. He also stated that certain characteristics of private equity, such as the ability to control portfolio companies in a way not completely transparent to investors and diminished investor oversight of older funds, may make the industry more susceptible to fraud. In addition, Mr. Karpati noted that increased competition in the areas of fundraising and deploying previously raised capital may incentivize private equity managers to engage in more aggressive, and possibly inappropriate, practices.

Mr. Karpati highlighted some particular concerns of the AMU with respect to the private equity industry:

- **Private equity products that lack transparency, especially with respect to the valuation of illiquid assets and the operations of portfolio companies.** Mr. Karpati noted, for example, the practice of writing up assets during fund raising and subsequently writing them down after the fund raising period closes.
- **Conflicts of interest that may lead to misappropriation, deal cherry-picking and other forms of misconduct.** Mr. Karpati noted the common conflicts he sees in the industry:
  - The conflict between the profitability of the management company and the best interests of investors, particularly where firms have publicly listed their management company shares.
  - The shifting of expenses from the management company to the funds, including using the funds' buying power to get better deals from vendors — such as law and accounting firms — for the management company at the expense of the fund.
  - Charging additional fees, especially to portfolio companies where the allowable fees may be poorly defined by the partnership agreement.
  - Conflicts arising from managing different clients, investors and products under the same umbrella, such as:
    - Broken deal expenses rolled into future transactions that may be ultimately paid by other clients.
    - Improper shifting of organizational expenses, where co-mingled vehicles pay the bill for preferred clients.

1 The full text of Mr. Karpati's comments is available at http://www.sec.gov/news/speech/2013/spch012313bk.htm.

> Complementary products supporting each other, such as a primary vehicle making fund commitments to create deal flow for a more profitable co-investment vehicle.

- Conflicts with a manager's other business, which may be run in parallel with the adviser and may incentivize managers to usurp investment opportunities or enter into related-party transactions at the expense of investors.

- **Misallocation of fund expenses for personal use**.

Mr. Karpati noted that while conflicts are inherent to the private equity business, "it is up to each manager to identify, control, and appropriately disclose material conflicts so that investors are informed and not harmed or disadvantaged."

Mr. Karpati also emphasized the role of CFOs, COOs and CCOs in ensuring that a manager complies with its fiduciary duties, particularly in private equity "where certain long held industry practices may be viewed as putting the manager's interest ahead of those of investors." He noted, for example, that "managers who offer co-investment opportunities only to certain favored clients may be violating their fiduciary duty to other clients who may also be interested in such opportunities." Mr. Karpati's comments on the role of CFOs, COOs and CCOs included the following recommendations for private equity managers:

- Integrate compliance risk into the overall risk management process.
- Implement compliance procedures that are appropriate for the firm's business model.
- Ensure that CFOs, COOs, CCOs and other risk managers are able to proactively spot and correct situations where conflicts of interest may arise.
- Ensure that CFOs, COOs and CCOs are part of the firm's important decision making processes.
- Use your Advisory Committee. Mr. Karpati noted that it is "inevitable that conflicts will arise in the management of your businesses, and disclosing the conflict to the Advisory Committee — or better yet, having it vote on the conflict — goes far in demonstrating good faith."
- Ensure that there is organizational authority to proactively identify and resolve potential issues.
- Be alert and prepared for exam inquiries.