CLIENT UPDATE

SEC ENFORCEMENT ACTION TARGETS ADVISERS TO PRIVATE EQUITY FUNDS

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The Securities and Exchange Commission ("SEC") announced earlier this week, on March 11, that it had settled charges against two affiliated private fund managers for misleading investors about the valuation and performance of a fund of private equity funds.[1] The action follows and reinforces recent public statements by agency officials that the SEC is focused on valuation policies and practices and, particularly for private equity fund managers, is concerned that managers may inflate portfolio valuations during fundraising periods.[2]

Private equity fund managers should expect that the number of SEC enforcement cases involving private equity fund managers will increase, and fund managers should be proactive in assessing the strength and adequacy of their compliance programs, especially in

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[1] *In the Matter of Oppenheimer Asset Management, Inc. and Oppenheimer Alternative Investment Management, LLC*, Admin Proc. File No. 3-15238 (Mar. 11, 2013).

[2] For a further discussion of the SEC's focus on valuation of the portfolio investments of private equity funds, *see* "Fund Directors Charged in Recent SEC Enforcement Case Targeting Valuation," Debevoise & Plimpton Client Update (Dec. 14, 2012), *available at* http://www.debevoise.com/files/Publication/76cc2b68-5b1a-4b58-9823-6e850693503e/Presentation/PublicationAttachment/df1713e1-7c59-427d-8145-0df56b25b77c/Fund%20Directors%20Charged%20in%20Recent%20SEC%20Enforcement%20Case%20Targeting%20Valuation.pdf

areas that the SEC has identified as enforcement priorities.[3] To provide greater assurance of a successful SEC exam and to prevent potential enforcement action, private equity fund managers should revisit their compliance and monitoring policies – including with respect to valuation of portfolio investments – to determine if they contain any "gaps" or fail to address risks of non-compliance.

THE SETTLEMENT

The two affiliated managers (together, the "Settling Parties") served as investment advisers to a private equity fund of funds (the "Fund"). The Fund began accepting limited partners in 2008 and by 2009 had made commitments to four investment vehicles, the largest of which was managed by a third-party manager (the "Underlying Fund") and invested in a single portfolio company formed by the Romanian government to compensate citizens who had their property seized by the communist regime.

According to the SEC, the marketing materials distributed to investors and potential investors represented that the Fund valued its holdings (consisting of interests in other private equity funds) "based on the underlying [fund] manager's estimated values." After the marketing materials were approved by the Settling Parties' compliance department, the Fund's portfolio manager changed the valuation methodology used by the Fund for its investment in the Underlying Fund and began valuing this investment at par value (the price at which the Romanian government issued shares to claimants) rather than using the estimated valuation provided by the manager of the Underlying Fund. This change significantly increased the Fund's internal rate of return (IRR) from 3.8% to 38.3%. The portfolio manager incorporated the new, higher valuation into performance numbers in the Fund's marketing materials without informing investors or the Settling Parties' compliance department of this change.

The SEC found that this undisclosed change in valuation methodology caused the Settling Parties to disseminate marketing materials and quarterly reports to investors that contained material omissions and misrepresentations concerning the Fund's valuation policies and performance for the period from October 2009 through 2010. The SEC also

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3 For a discussion of the SEC's broader examination and enforcement initiatives with respect to private funds, *see* "When the SEC Knocks on Your Door, Will You Be Prepared?: Practical Steps PE Firms Should Take to Prepare for an SEC 'Presence' Examination," Debevoise & Plimpton Private Equity Report (Winter 2013), *available at* http://www.debevoise.com/files/Publication/fb532cfa-68ee-4c7e-a647-1eac43372be6/Presentation/PublicationAttachment/2ae8601d-1aa6-494b-80b5-f0ea18c11f81/PE_Report_Winter_2013.pdf and "SEC 2013 Examination Priorities Focus on Private Fund Sponsors," Debevoise & Plimpton Client Update (Mar. 5, 2013), *available at,* http://www.debevoise.com/files/Publication/9ad8f768-3b97-4dd7-90be-5f3584968411/Presentation/PublicationAttachment/d17d308d-172c-456d-a5af-9dccd7e454df/SEC%202013%20Examination%20Priorities%20Focus%20on%20Private%20Fund%20Sponsors.pdf

found that the Settling Parties had represented that (i) the increase in the Underlying Fund's value was due to an increase in performance when, in fact, the increase was attributable to the Portfolio Manager's new valuation method; (ii) a third-party valuation firm used by the Underlying Fund's manager wrote up the value of the Underlying Fund when that was not true; and (iii) the underlying funds were audited by independent, third-party auditors when, in fact, the Underlying Fund was unaudited. As a result, the SEC found that the Settling Parties had violated the anti-fraud provisions of the Securities Act of 1933 and the Investment Advisers Act of 1940 (the "Advisers Act").

The SEC also found that, because the Settling Parties' compliance department was required to review and approve marketing materials but was not required to review portfolio manager valuations, the Settling Parties' compliance policies and procedures were deficient. Thus, the SEC found that the Settling Parties had violated Advisers Act Rule 206(4)-7, which requires registered investment advisers to maintain policies and procedures designed to prevent violations of the Advisers Act.

In settling the matter, the Settling Parties agreed to significant undertakings that include a distribution to investors of $2,269,098, representing the management fees plus interest paid by investors in the Fund during the relevant time period. The Settling Parties also agreed to retain an independent consultant to conduct a review of its valuation procedures, recommend additional policies and procedures, and submit to the SEC periodic reports on the status of the Settling Parties' implementation of the consultant's recommendations.

KEY TAKEAWAYS AND LESSONS LEARNED

The recent settled action is another example of the SEC's continued prioritization of asset valuation issues in its enforcement investigations, a priority that the agency highlighted at the end of last year with a trio of cases (none of which involved private equity funds) concerning the valuation of illiquid securities.[4] Bruce Karpati, Chief of the SEC Enforcement Division's Asset Management Unit, gave a speech earlier this year highlighting his view that the same types of valuation issues could arise in connection with private equity funds.[5] While this recent action involved a fund of private equity funds (and not a private equity fund making direct investments in portfolio companies), it provides another example of the SEC's focus on valuation, particularly in connection with

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4 *SEC v. Yorkville Advisors, LLC*, Civil Action No. 12-CV-7728 (S.D.N.Y., Oct. 17, 2012); *In the Matter of J. Kenneth Alderman, CPA et al.*, Administrative Proceeding, File No. 3-15127 (Dec. 10, 2012); *In the Matter of KCAP Financial Inc., et al.*, Administrative Proceeding, File No. 3-15109 (Nov. 28, 2012).

5 Bruce Karpati, "Private Equity Enforcement Concerns," remarks at the Private Equity International Conference (Jan. 23, 2013).

fund marketing. The SEC's consistent position has been that "interim valuations do matter" and fund managers should expect that the agency will scrutinize instances where a fund manager may have exaggerated the quality or performance of the holdings that it manages when marketing a new fund to potential investors.[6]

Mr. Karpati's remarks and recent SEC settlements provide some useful lessons for private equity fund managers:

- **Private equity fund managers should heed Mr. Karpati's warning that "it is not unreasonable to think that the number of cases involving private equity will increase."**

Private Fund Managers should proactive in assessing whether their compliance policies and procedures are appropriately robust – especially in areas that the SEC has identified as enforcement priorities. Private equity fund managers should also assess whether their compliance policies and procedures are tailored to the particular risks of their business and should monitor and test whether, in fact, those policies and procedures are being followed.

- **As we have discussed in previous client alerts, private equity fund managers should also expect that the SEC's National Exam Program ("NEP") will closely review a private equity firm's valuation policies and procedures for valuing the holdings of the funds that it manages.**

The NEP has identified performance marketing as an examination priority for investment advisers in 2013.[7] The SEC staff likely will evaluate whether a firm followed its policies and procedures and used the assumptions and methodologies it had told investors it would use when valuing fund portfolio investments. The staff can be expected to examine performance (track record) presentations in private placement memoranda, flip books and other marketing materials, and other valuation and performance discussions (such as quarterly and other reports to fund investors).

- **To provide greater assurance of a successful exam and to prevent potential enforcement issues, private equity fund managers should revisit their compliance and monitoring policies to determine if they contain any "gaps" or fail to address risks of non-compliance by firm employees.**

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6 *Id*.

7 "National Exam Program: Examination Priorities for 2013" (Feb. 21, 2013), *available at* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf

In this regard, the recent settlement provides a cautionary tale: although accurate performance numbers were included in the marketing materials initially reviewed and approved by the Settling Parties' compliance department, the flaw in the Settling Parties' compliance policies was their failure to require a review of underlying portfolio manager valuations.

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Please do not hesitate to contact us with any questions.

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