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INVESTMENT ADVISERS

New Developments in the SEC's Focus on Private Funds

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Recently, the Securities and Exchange Commission has focused, and continues to focus, attention on the details of accounting within private funds. In recent months, the SEC has settled one such enforcement action (*In re Clean Energy Capital, LLC and Scott A. Brittenham*, SEC Rel. No. 9551, Order Instituting Administrative and Cease-and-Desist Proceedings (Feb. 25, 2014)), brought and settled a new action (*In the Matter of Lincolnshire Mgmt., Inc.*, SEC. Rel. No. 3927, Order Instituting Cease-and-Desist Proceedings (Sept. 22, 2014)), and appears to be looking closely at other accounting and economic-related issues within private equity and hedge funds. This scrutiny and related enforcement actions demonstrate that fund sponsors should take seriously the warnings the SEC is disseminating to the market.

Recent SEC Focus on Private Equity Fund Advisers' Fee and Expense Disclosure Practices

As part of its Presence Exam Initiative, the SEC's Office of Compliance Inspections and Examinations (OCIE) closely reviewed private equity fund advisers' disclosure of fee and expense allocations to their investors. The SEC reported widespread violations of law or material weaknesses in controls related to the allocation of fees and expenses among the newly registered private equity advisers it examined. On May 6, 2014, Andrew J. Bowden, Director of the OCIE, stated that his office found extensive evidence of insufficiently disclosed fees in the private equity industry, particularly payments to consultants, expenses shifted from a fund manager to the fund sometime after the fund's inception, characterization of expenses traditionally thought to be part of the management fee as fund expenses, and a variety of hidden fees.[1] Undisclosed fees and expenses may run afoul of the securities laws, creating the risk of both regulatory actions and investor lawsuits based on claims of purported fraud, misrepresentation, breach of fiduciary duty and breach of limited partnership agreements. Although the typical rule is that a fact is material and must be disclosed if there is a substantial likelihood that the disclosure of this omitted fact would be viewed by a reasonable investor as important to its investment, there is the prospect that the SEC or investors may claim that any undisclosed allocation of fees and expenses is material.

Recent SEC Enforcement Actions Related to Fee and Expense Allocation

The *Clean Energy* Action

In February 2014, the SEC brought charges against Clean Energy Capital, LLC (CEC), and its main portfolio manager, Scott Brittenham. The SEC alleged that CEC and Brittenham improperly allocated more than $3 million of CEC's expenses to certain private equity funds that CEC managed. The SEC alleged such allocations were made without adequate disclosure to investors, and therefore constituted a misappropriation of assets from the CEC funds. Such alleged improper expenses included the salaries of the majority of CEC employees, executive bonuses, health benefits, retirement benefits and rent. We note that these kinds of expenses are typically paid by the fund manager out of the management fees that it receives from the fund, rather than charged to the fund. The SEC also alleged that CEC and Mr. Brittenham secretly caused the funds to borrow money to pay the expenses from CEC at unfavorable rates, pledging the funds' own assets as collateral.

On Oct. 17, 2014, CEC and Brittenham agreed to pay $2.2 million to settle the action. CEC and Brittenham neither admitted nor denied the final charges, which were listed in the settlement as fraud caused by negligence, a shift from the SEC's initial charges of intentional fraud. Marshall Sprung, a Co-Chief of the Enforcement Division's Asset Management Unit, described the *Clean Energy* settlement as ''a very strong settlement that reinforces the message we want to send about transparency in the private equity space.'' Accordingly, the lesson from *Clean Energy* is that the SEC is taking the allocation of fees and expenses seriously and is prepared to take action if it discovers infractions in this area.

The *Lincolnshire* Action

On Sept. 22, 2014, the SEC entered a cease and desist order against Lincolnshire Management, Inc. (LMI), finding, among other things, that LMI violated Section 206(2) of the Investment Advisers Act of 1940 by breaching its fiduciary duty owed to its funds. The SEC charged LMI with failing to allocate expenses properly after LMI integrated portfolio companies of two affiliated private equity funds (which did not have common ownership) and managed the two portfolio companies together, with the two companies sharing certain annual expenses based on each company's contributions to their combined revenue. The SEC charged that this expense allocation policy was not faithfully followed. Julie M. Riewe, a Co-Chief of the Enforcement Division's Asset Management Unit, explained: ''Advisers that commingle assets across funds must do so in a manner that satisfies their fiduciary duties to each fund and prevents one fund from benefiting to the detriment of the other.'' Although LMI neither admitted nor denied the charges, which included a failure to adopt and implement written policies and procedures reasonably designed to prevent Advisers Act violations, LMI was ordered to cease and desist from such violations, and agreed to pay the SEC $2.3 million to settle the charges.

The basic lesson from *Lincolnshire* is that allocations among multiple entities must be equitable. The broader lesson is that the methodology of such allocations should be included within a fund's compliance manual and there should be clear written policies and procedures in place to effectuate such allocation. Fund managers should maintain documentation of expense allocation policies and procedures, and any changes thereto, in order to demonstrate compliance to the SEC.

Next Potential Areas of SEC Attention

The SEC staff has demonstrated interest in other areas as it continues to expand its scope of inquiry into private funds. First, the SEC is reportedly reviewing how private equity firms disclose calculation of average net returns in their marketing materials. Net returns, or net internal rates of return (IRR), may be used by prospective investors as a measure of actual profits. Net IRR reports fund profits after deducting the fund investors' expenses and fees (including any carried interest distributions made to the general partner). Typically, the general partner of a fund also contributes its own money to the fund, but does not pay any fees. Thus, inclusion of the general partner's money tends to skew higher the fund's average net performance figure. There is no standard practice for calculating this figure, although it is a safe bet the SEC will focus on whether such calculation is adequately disclosed to a fund's investors.

Second, the SEC staff has also turned its attention to private equity consultants, also known as ''operating partners.'' These are individuals whom fund managers engage to provide assistance to portfolio companies. According to Director Bowden, operating partners ''walk, talk, act and look just like employees or affiliates'' of the fund manager, however, unlike actual employees of the fund manager (the expense of which is generally borne by the fund manager), operating partners are either paid directly by the portfolio companies they advise or their compensation is expensed to the fund. According to Director Bowden, this arrangement is often not sufficiently disclosed to investors. As a result of the SEC focus on this and similar accounting issues, the Oregon Investment Council, which manages Oregon's approximately $88 billion in retirement assets, is reportedly reviewing its portfolio to verify the expenses charged by private equity funds. The lesson learned here is that the SEC's comments on an area of its focus may spark investor inquiry as to a particular issue.

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Third, the SEC staff is also focusing on specific issues related to hedge funds, including valuation practices. For example, the SEC has criticized firms for changing valuation techniques multiple times over the course of a year to boost an asset's value, and for classifying assets in a manner that makes their valuation subject to greater management discretion. The SEC is questioning whether such practices have been disclosed adequately to investors and whether the methodologies employed by the funds are appropriate and sufficiently based on objective market data. The SEC has demonstrated its willingness to bring enforcement actions over valuation issues, charging, for instance, Yorkville Advisers LLC in 2012 with exaggerating its returns to hide losses and inflate management fees. This matter is currently being litigated in a public enforcement proceeding.

The SEC staff has stepped up its focus on detailed economic points related to both private equity and hedge funds. As an ancillary result, certain sophisticated investors will likely dig deeper into the same issues that the SEC has raised and likely will continue to raise in its public comments. Accordingly, fund managers will have heightened exposure both to regulatory and investor inquiry and potential action. As a result, fund managers need to focus on disclosure, compliance and valuation approaches and methodologies.