Q&A Remarks at the Private Equity International Conference

by

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Thank you to Private Equity International for having me here today. I am grateful for the opportunity to speak about our work in the private equity space. First, let me start by saying that my comments here today are mine and mine alone, and do not represent the views of the SEC, the Commissioners, or the staff.[1]

Q1: As many are aware, in 2010 the Commission reorganized part of the Division of Enforcement into specialized units. How has the creation of the Asset Management Unit impacted the Commission's activities in the private equity space?

In 2010, the Commission created five specialized units within the Division of Enforcement to address specific areas of the financial markets where specialization would enhance the Commission's ability to carry out its investor protection mission. The Asset Management Unit, of which I am a part, is the largest of those units and focuses on investment advisers and investment companies, which of course includes managers of private equity funds. It's worth mentioning that we are national in scope — we have approximately 75 staff across 11 offices covering large metropolitan areas with high concentrations of private equity managers.

Since its creation, the Unit has focused on generating expertise with the goal of understanding each area that we cover. We want to understand the structure of the industry, the customs and practices, the incentives that exist for managers, and trends and risks that could enable us to more effectively spot or investigate fraud. We've done a number of things to generate that expertise.

First, we have hired industry specialists that have deep asset management industry experience. For example, our private equity specialist has been a deal professional executing transactions, as well as an LP performing manager selection at a large institution. These experiences enable him to help us understand and unravel complex transactions, as well as to gauge whether, for example, certain disclosures or conduct would be important to investors. In addition to private equity, we've hired a number of other former industry professionals, including people from hedge funds, mutual funds and due diligence firms.

Also, each AMU staff member has a specialty area and has generated a detailed plan addressing either a type of investment vehicle or an investment practice. That means that when we launch an investigation, we are able to hit the ground running with an understanding of the unique characteristics of each vehicle or practice and the pertinent legal issues. Finally, we have several attorneys with practical private equity investigative experience that will be crucial to future private equity inquiries.

Our expertise has also enabled us to enhance the Enforcement Division's investigative capabilities. For instance, we are now able to identify promising cases earlier. By its nature, fraud is hidden and our ability to detect anomalies — a fee calculated in an odd way, a unique valuation methodology, an incomplete disclosure made to investors — has helped us to better allocate resources.

Also, we are much better able to take on cases that have a variety of complex and technical issues. You won't see the Enforcement Division or the AMU shy away from cases that involve illiquid asset valuations or that require us to dig into the operations of a portfolio company.

We also collaborate across the Commission in areas where we can utilize our industry knowledge to further the Commission's mission. One significant area of collaboration is with our National Exam Program. AMU personnel have helped train examiners and have accompanied them on exams of private equity managers. In return, the National Exam Program has enhanced our understanding of the private equity industry with observations and insights from examinations. As I mentioned before, to be effective we need to be on the leading edge of industry trends. Since many of the Commission's interactions with the industry are through the exam staff, examiners are absolutely critical in making sure that we are aware of important issues.

We also frequently engage with our Division of Investment Management colleagues on the legal aspects of private equity. IM staff assists us in addressing complex legal and contractual issues that crop up in our investigations. They also consult with us when they are writing rules that impact the private equity industry. We likewise keep them apprised of how regulation impacts the PE industry -- for example, how custody or personal transaction monitoring are affecting, and being implemented by, the private equity industry.

Finally, we are using our industry knowledge to develop and execute on risk analytic initiatives where we use data and quantitative analysis to proactively detect fraud and identify other problematic industry practices.

Q2: The Commission hasn't traditionally brought many private equity enforcement actions. Do you expect that to change?

Private equity went through a significant growth spurt in the run-up to the financial crisis and is a rapidly maturing industry. In terms of assets under management, it's roughly equivalent to, and perhaps larger than, the hedge fund industry. Also, many private equity managers have only recently become registered investment advisers. As a result of these developments, it's not unreasonable to think that the number of cases involving private equity will increase. Many in the private equity industry have pointed to the greater perceived alignment of interests in private equity products — for instance, in the way carried interest is paid on realizations and not on net asset values but private equity has other unique characteristics that may make the industry more susceptible to fraud, for example, the ability to control portfolio companies in a way not completely transparent to investors.

Private equity funds have long lives and investors have little ability to obtain liquidity. We've found that as a fund ages, investors become less engaged and may devote fewer and fewer resources to monitoring the fund. This can occur for a variety of reasons — institutional investors may feel constrained in their ability to directly address issues; an investor's strategy may have shifted and the fund may no longer be part of the investor's core portfolio; or the investor may have already written the fund off. Whatever the reason, diminished investor oversight of older funds makes investors in those funds susceptible to fraud in a way that hedge funds investors — who generally make more frequent decisions about whether to increase, decrease or maintain their position in a fund — are not.

The Division has been bringing more private equity cases, as well as hedge fund and registered fund cases with private equity-like issues. There are several cases that I would like to highlight as being indicative of the type of misconduct that can occur:

- The *Matthew Crisp* case concerns an individual who allegedly usurped an investment opportunity from private equity funds managed by Adams Street. Crisp was able to redirect the investment opportunity to a fund that he co-managed, the existence of which was allegedly not disclosed to Adams Street or Adams Street Investors.[2]

- The *Robert Pinkas* case is an example of an enforcement action concerning the misallocation of expenses. Pinkas, who was the principal of private equity manager Brantley Capital, allegedly misappropriated funds from a private equity fund and applied those funds to expenses that he incurred defending himself from a different SEC action related to another Brantley Capital entity. The temptation to misallocate fund expenses is a risk we frequently cite and that we see as a form of misappropriation.[3]

- The *Advanced Equities* case concerned alleged misstatements made to investors about the performance of a portfolio company. While this case involved a broker dealer, not an investment adviser, fund managers make representations about their portfolio companies in the course of their business and this case highlights the importance of these types of representations.[4]

- In the *Resources Planning Group* case, it is alleged a private equity principal used fund assets to repay previous investors. He allegedly misrepresented his fund as a viable entity while failing to tell investors about the fund's poor financial health and misappropriating investor funds to repay loans from other investors.[5]

- In *SEC v. Onyx Capital Advisors*, Roy Dixon, principal of Onyx Capital, allegedly took more than $2 million from a fund purportedly as advance management fees. Numerous public pension funds had invested in the fund.[6]

- The *Gowrish* insider trading case involved an individual who allegedly stole confidential acquisition information from his employer, TPG Capital, and sold that information to two friends who made $500,000 in illicit trading profits.[7]

- Recently, the Commission filed a case against *Yorkville Advisors* where Yorkville allegedly inflated the values of certain illiquid assets. While Yorkville managed hedge funds, the valuation issues are very similar to ones we see in private equity.[8]

- Finally the *KCAP* valuation case involved alleged overstatements of the value of certain debt securities and CLOs held in an investment portfolio, highlighting the Division and AMU's emphasis on pursuing valuation cases.[9]

We recognize that the unique aspects of private equity may present different enforcement issues than we typically observe with other investment advisers. However, we have identified enough misconduct to know that enforcement oversight of the private equity industry is important for investor protection.

Q3: What are some of the Unit's concerns about practices in the private equity industry?

I'd be happy to discuss what issues we think are important, but our list is always evolving, so first I'd like to discuss the process we use to assess the industry and select focus areas. We monitor the industry closely and seek to understand industry drivers, dynamics and incentives. First we look for areas of industry change and pay specific attention to areas that lack transparency, where fraud may occur undetected, or where there may be ambiguity that creates the opportunity to engage in fraud. We then combine our industry expertise with observations from exams, investigations and discussions with industry professionals to determine which risks warrant special attention by the Unit.

Today, we find some of the main industry stressors to be fundraising and capital overhang. The recent rapid growth in assets under management in the private equity industry has resulted in many managers with similar strategies and return profiles. This rapid growth was followed by a contraction in the amount of capital available to new funds. At the same time, many funds still have a significant amount of uninvested capital that was raised during the boom times. This capital will expire if it's not put to work which means that there is more capital chasing the same number of deals, which puts extra pressure on returns. Given these pressures, many managers around today will likely not be around 10 years from now — and many are even now fighting for their survival. These dynamics may incentivize managers to engage in aggressive marketing and may lead some to cross the line into inappropriate behavior.

We also see that many private equity products lack transparency, especially into the valuation of illiquid assets and the operations of portfolio companies. Valuations, while always important, take on greater significance during the period of fund marketing. One type of manager misconduct that we've observed involves writing up assets during a fund raising period and then writing them down soon after the fund raising period closes. Because investors and potential investors often question the valuations of active holdings, managers may exaggerate the performance or quality of these holdings. This type of behavior highlights something that I'm sure many of you already know — that interim valuations do, in fact, matter. In the course of running their business, private equity managers often tweak strategies, change teams and raise funds of increasing size. While everyone understands that the true measure of value is a realization event, data from older realized investments may not be relevant to a decision to commit capital to a new fund and interim valuations may be the best data available to investors at any particular time.

Much of the improper conduct in private equity arises out of conflicts of interest, which can lead to misappropriation, deal cherry picking and other forms of misconduct. I'd like to discuss those conflicts and talk about the types of issues they present. While each adviser may have a different set of conflicts, some common ones

include:

- The conflict between the profitability of the management company and the best interests of investors. This conflict exists at all firms, but may be particularly acute at firms that have publicly listed their management company shares and may therefore feel additional pressure from their public shareholders to generate short-term results.

- The shifting of expenses from the management company to the funds including utilizing 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 the 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. We have observed troubling behavior caused by this conflict, for example:

    - Broken deal expenses rolled into future transactions that may be ultimately paid by other clients. We've seen certain preferred clients incur no broken deal expenses at all, which are all absorbed by a core co-mingled fund.

    - Improper shifting of organizational expenses, where co-mingled vehicles foot the bill for preferred clients.

    - 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.

Although conflicts of interest are a natural part of 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.

Q4: You've spoke before about AMU's Risk Analytic Initiatives. What are they and are there any currently under way in the private equity industry?

Risk analytic initiatives, or RAIs, seek to proactively detect problematic conduct through the use of data and quantitative methods. When designing RAIs, we use the expertise that we have created in the unit to identify high risk areas that lack transparency, are not monitored by investors, or have some other quality indicative of fraud. We then analyze how such conduct would express itself in data and from there design the analytical and investigative framework. RAIs often bring together expertise from, among others, the Asset Management Unit, the National Exam Program, the Division of Investment Management and the Division of Risk, Strategy and Financial Innovation. We have a number of active RAIs, including one targeting conduct at private equity managers.

The Private Equity Initiative seeks to identify private equity managers who have assets under management but are unable to raise follow on vehicles. Our thesis for this initiative is that the rapid growth of the industry, combined with the current difficult fundraising environment and converging need for steady private equity returns, will naturally push certain managers out of the business. "Zombie funds" (or more accurately, "zombie managers") result when private equity holdings are not designed for quick liquidity. Since zombie managers are unable to raise new capital, their incentives may shift from maintaining good relations with their investors to maximizing their own revenue using the assets that they have. Being a zombie manager in and of itself is of course not unlawful and most zombie managers will continue to act in the best interests of their investors. However, given the incentives to favor their own interests, we believe that there will be some problematic conduct and possible violations of the law.

To launch this initiative, we used data about funds' portfolios and looked for funds with unusually low liquidity compared to their peers. In examinations and investigations of the target funds, we look for misappropriation from portfolio companies, fraudulent valuations, lies told about the portfolio in order to cause investors to grant extensions, unusual fees, principal transactions, as well as other

situations that concerned us. We think the zombie manager issue is significant and given the large amount of capital raised in 2006 and 2007, will likely become more important when those vintages reach maturity.

Q5: What can a private equity COO or CFO do to reduce the risk of inquiry by the Division of Enforcement?

Private equity COOs and CFOs are absolutely critical in making sure that clients' interests are placed ahead of the interests of the management company and its principals. As you know, the Investment Advisers Act of 1940 imposes on investment advisers a broad fiduciary duty to act in the best interest of their clients. This means that investment advisers have "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading'... clients."[10] As a fiduciary, a private equity manager must guard against conscious and unconscious incentives that might cause him or her to provide less than disinterested advice, since an investment adviser may be faulted even when he or she does not intend to injure a client or even if a client does not suffer a monetary loss.[11]

The fiduciary duty is the lens through which the AMU looks at many of the issues it investigates, and the anti-fraud provisions of the Investment Advisers Act (including Sections 206(1) and (2) and Rule 206(4)-8)) enable the AMU to pursue breaches of fiduciary duty and other forms of misconduct.

Since private equity COOs and CFOs are charged with overseeing the business of the investment manager, they are best positioned to detect and correct conduct that may not comply with the fiduciary duty standard. This job is especially important in private equity, where certain long held industry practices may be viewed as putting the manager's interest ahead of those of investors. For instance, 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.

Private equity firms should integrate compliance risk into their overall risk management process and should ensure that COOs, CFOs, CCOs and other risk managers are able to proactively spot and correct situations where conflicts of interest may arise. Also, COOs, CFOs and their firms should implement a set of compliance procedures that are appropriate for their business model. Given the transactional focus of most private equity shops, it may make sense to assign an experienced deal professional who has some understanding of compliance issues to help review and implement some of these procedures.

COOs, CFOs and CCOs should be part of the firm's important decision making processes and should act as investor advocates. For instance, if a COO, CFO or CCO is a member of the investment committee, they can ensure that the firm executes transactions at arm's length and in accordance with the firm's stated strategy. They can also learn about the operation of the firm's portfolio and use that knowledge to ensure that valuations are fairly represented and that investors are accurately informed of the status of their investment. In addition, firms may find that implementing such procedures will help attract and retain sophisticated, institutional investors.

One of the best, easiest and most underutilized ways to ensure that your firm and its principals are meeting their fiduciary responsibilities and being transparent with investors is to utilize your Limited Partnership Advisory Committee. In many instances, these committees have explicit responsibility to resolve conflicts of interest but all too often may not be used. 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.

Also, having the organizational authority to proactively identify and resolve potential issues is significant. Some of you may discover a situation that you think has violated the trust that your investors have placed in your firm. In those cases, it is important to immediately resolve the problem. I would encourage everyone who comes across such a situation to consult with your internal compliance department and your counsel to determine the proper resolution.

Finally, I think all investment advisers need to be alert and prepared for exam inquiries. It is important to be cooperative with exam staff while an examination takes place. It is also important to implement any necessary corrective steps if the SEC staff identifies deficiencies or possible violations. Taking these steps will help the examination process to proceed more efficiently and reduce the likelihood of more

formal inquiries by the Enforcement Division or AMU staff.

Thank you again for this opportunity.

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

[2] In re Crisp, Adm. Proc. File No. 3-14520 (instituted Aug. 30, 2012).

[3] In re Pinkas, Adm. Proc. File No. 3-14759 (instituted Feb. 15, 2012).

[4] In re Advanced Equities, Inc., Adm. Proc. File No. 3-15031 (instituted Sept. 18, 2012).

[5] SEC v. Resources Planning Group, Inc., No. 12-cv-9509 (N.D. Ill. filed Nov. 23, 2012).

[6] SEC v. Onyx Capital Advisors, LLC, No. 10-cv-11633 (E.D. Mich. filed April 22, 2010).

[7] SEC v. Gowrish, No. 09-cv-5883 (N.D. Cal. filed Dec. 16, 2009).

[8] SEC v. Yorkville Advisors, No. 12 Civ. 7728 (S.D.N.Y. filed Oct. 17, 2012).

[9] In re KCAP Financial, Inc., Adm. Proc. File No. 3-15109 (instituted Nov. 28, 2012).

[10] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (citation omitted).

[11] *Id.* at 191-192.

http://www.sec.gov/news/speech/2012/spch012313bk.htm
