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Compliance Lessons For PE Sponsors Amid SEC Scrutiny

By **Andrew Lom and Garry Padrta** (December 2, 2021, 6:15 PM EST)

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The private equity industry's success over the last decade, in terms of its size and the returns it has generated investors, has been unprecedented.[1] That success has not gone unnoticed with the investing public clamoring for access to private equity and U.S. regulators responding in turn by broadening certain parameters of eligible private equity investors.[2]

But as private equity funds have increased their profile with the investing public, they have also found themselves subject to greater political scrutiny.[3]

Notably, the U.S. Securities and Exchange Commission has become increasingly vocal in its focus on private equity.

In June 2020, for example, the SEC's Division of Examinations — then the Office of Compliance Inspections and Examinations — issued a high-profile risk alert identifying common compliance deficiencies that it found in regulatory examinations of private equity funds, emphasizing issues in the areas of conflicts of interest and adviser fee and expense disclosures, known as the risk alert.[4]

Similarly, SEC Chairman Gary Gensler's congressional testimony on May 26 noted his belief in the propriety of increasing enforcement actions against private equity managers and indicated that his regulatory agenda would include prioritizing new rules reforming the private equity industry.[5]

However, while the SEC's recent scrutiny of private equity firms has been frequent, it has mostly been generalized, omitting the details of what any SEC reforms are likely to include, leaving private equity sponsors somewhat in the dark on how to best respond.[6]

Against this regulatory backdrop, Gensler's Nov. 10 speech at the Institutional Limited Partners Association Summit is particularly noteworthy, as it is the first time the SEC head has publicly provided additional details both of potential new rules targeting the private equity industry and what sponsor practices are likely to be the subject of the SEC's renewed enforcement focus.[7]

Gensler's statements offer valuable insight to private equity sponsors seeking to improve their compliance programs and practices in light of the commission's increased focus on private funds, as well as institutional investors evaluating or monitoring their private equity investments.

Conflicts of Interest and Fiduciary Duties

Gensler's remarks put enhanced scrutiny over potential conflicts of interest between private equity sponsors and their limited partners at the front and center of the SEC's regulatory agenda.

While his speech did not specify the conflicts of interest any new SEC rules are likely to address, the aforementioned risk alert notes the myriad conflicts of interest identified in recent SEC examinations of private equity sponsors.

This includes sponsors offering certain investors preferential co-investment opportunities; portfolio companies engaging in non-arm's length transactions with private equity-sponsor controlled affiliates; and sponsors failing to disclose financial interests they have in counterparties to various fund or portfolio company transactions.

Each of these undisclosed acts of self-dealing called out by the SEC are textbook examples of what would likely subject a nondisinterested public company director to shareholder breach of duty of loyalty claim.

Yet, at least under the SEC's view, private equity sponsors and their principals do not also appear similarly concerned with their status as fiduciaries of their limited partners, despite that — as Gensler reiterated — unlike waivers of fiduciary duties permitted under Delaware corporate law, a fund sponsor's fiduciary obligations imposed under the Investment Advisers Act cannot be waived, even by the most sophisticated limited partner.[8]

Managing conflicts of interest should thus be high on the radars of both private equity sponsors and their stakeholders. Given a private equity sponsor's unwaivable fiduciary duty, each of the problematic transactions identified in the risk alert could subject a private equity sponsor or its principals to personal liability in the event of a limited partner lawsuit or an SEC enforcement action, the latter increasing as a concern in light of Gensler's statements regarding the SEC's enforcement priorities.

Such litigation risk is unfortunate given it can often be easily mitigated or eliminated entirely. Borrowing well-defined corporate governance rules applicable to public companies developed over decades of Delaware litigation, there are a plethora of tools at private equity sponsors' disposal to reduce the risk of liability — including well-structured disclosures and disinterested party approval.

As such, private equity sponsors considering a potentially conflicted transaction, either directly or indirectly through a portfolio company or affiliate, should put on their public company board member hat when considering how to structure any disclosures or obtain any approvals in connection therewith.

Gensler's speech should also serve as a reminder to limited partners that their interests may not always be aligned with private equity sponsors and they may wish to consider negotiating additional protections and oversight over such conflicts.

Side Letters

Gensler's ILPA comments also reaffirm and clarify the SEC's attention to private equity firms' use of side letters.

A positive takeaway for private equity sponsors is that Gensler clarified the commission's concerns are not with benign uses of side letters such as addressing esoteric investor jurisdictional or regulatory books and

records requirements.

Instead, the chairman expressed concern, also addressed in the risk alert, regarding select limited partners benefiting from side letters — the terms of which private equity sponsors often contractually agree not to disclose to other investors — to negotiate for additional information rights or special liquidation preferences not shared with other investors, and notified the public that he has asked the SEC to consider promulgating new rules either prohibiting providing such terms through side letters or requiring their disclosure to other investors.

In light of this increased scrutiny on the use of side letters, private equity sponsors should not necessarily expect confidential treatment of side letters to continue.

Additionally, while Gensler's remarks suggest that the SEC is only likely to issue additional regulations regarding a subset of side letters, until such time that the SEC makes any proposed rules subject to public comment, we cannot be certain. Private equity sponsors should thus be increasingly scrupulous about granting side letters, especially in connection with preferential information rights or economic preferences.

Further, private equity investors should be wary of relying on side letters lest new regulations eviscerate the protections or undisclosed advantages they have included in a private equity fund's value proposition.

Inadequate Disclosures

The final area Gensler addressed concerns the quality of private equity sponsor investor disclosures, specifically in the areas of fees and expenses and performance measurements.

With respect to sponsor fee arrangements, Gensler echoed a concern from the risk alert that private equity sponsors are not always fully transparent about the fees they, or their affiliates and representatives, charge portfolio companies, and thus that limited partners do not receive the economic benefit of, or that may otherwise be duplicative of a sponsor's management fee.

Examples include portfolio company monitoring fees, board participation fees, and fees for closing certain transactions such as add-on acquisitions or third-party financings. With respect to performance metrics, he similarly expressed concern that, despite certain Advisers Act rules, private equity sponsors may not always be forthright when disclosing their performance results.

He further advised that he has requested the commission to consider adopting new rules governing the requirements of private equity sponsor disclosures in these areas.

Although Gensler's remarks were sparse on details concerning the likely content of any SEC sponsor disclosure regulations, there are nevertheless important preemptive actions private equity stakeholders ought to consider taking now.

First, the consistency of the SEC's concern with sponsor fee and performance disclosures clearly indicates that SEC believes that, based on its aggregate review of the information available from examining private equity's sponsors, current market dynamics do not adequately protect investor interests. Private equity investors may therefore wish to negotiate for additional information rights in response.

For sponsors, Gensler's remarks signal the SEC is prioritizing reviewing disclosures in these areas in

connection with exercising the expansive enforcement powers granted under the Advisers Act's anti-fraud provisions.[9]

Private equity sponsors should not only review how they're disclosing their performance and management fees and, critically, the fees they or their agents charge to portfolio companies to ensure that their investment documents are fully transparent — but they should also review their financial controls to ensure they adequate track the direct and indirect fees and expenses they charge portfolio companies and apply them in accordance with the terms of their fund documents, i.e., against any management fee offset provisions.

Such review should mitigate the risk of the SEC identifying inadequate compliance in these areas to be an actionable fraudulent or manipulative practice and thus serving as a basis for a potential enforcement action.

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[1] https://news.bloomberglaw.com/business-and-practice/insight-the-family-office-as-private-equity-investor.

[2] Chairman Jay Clayton, "Statement on modernization of the accredited investor definition," U.S. Securities and Exchange Commission, August 26, 2020. U.S. Department of Labor, "U.S. Department of Labor issues information letter on private equity investments," news release, June 3, 2020.

[3] https://www.bloomberg.com/news/articles/2021-10-20/warren-renews-assault-on-private-equity-payouts-worker-policies.

[4] https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

[5] https://www.sec.gov/news/testimony/gensler-2021-05-26.

[6] https://www.privateequityinternational.com/sec-explores-potential-reforms-around-private-equity-fee-expense-disclosure/.

[7] https://www.davispolk.com/insights/client-update/sec-chair-gensler-signals-increased-regulatory-scrutiny-private-fund.

[8] Release No. IA-5248; File No. S7-07-18 (Commission Interpretation Regarding Standard of Conduct for Investment Advisers).

[9] https://webstorage.paulhastings.com/Documents/PDFs/739.pdf.