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Private Equity: The Next Wave of SEC Enforcement Actions?

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Ever since the Dodd-Frank Wall Street Reform and Consumer Protection Act required many investment advisers to private equity funds to register with the SEC for the first time, fund managers knew that additional scrutiny might eventually follow. The SEC then launched the Presence Exams Initiative in October 2012, specifically to examine the operations of private equity investment advisers. Now, the Commission seeks to greatly increase the size of the task force examining the private equity industry. As a result of these developments, much of the private equity industry is now subject to registration, a new compliance infrastructure, and soon, perhaps, the next round of SEC enforcement actions. Currently, the SEC is most focused on fund manager practices related to disclosure of management fees, valuation of assets, and conflicts of interest. From the Commission's perspective, the discretionary nature of certain undisclosed fund expenses and the potentially inflated valuation of illiquid assets held by private equity funds are of special concern. Given the SEC's mobilization and commitment of resources to the examination of private equity, the scrutiny of investment advisers of privately managed funds will inevitably increase. Recent comments by Andrew Bowden, Director of the Office of Compliance Inspections and Examinations for the SEC, indicated that more than half of the 150 investment fund manager examinations completed so far reveal what the SEC believes to be violations of law or material weaknesses in compliance controls regarding the collection of fees and allocation of expenses imposed by investment advisers against managed funds. Examples included shifting of staff costs onto portfolio companies or to third-party contractors, undisclosed fee arrangements with operating partners, fee-shifting, and the use of accelerated monitoring fees charged to portfolio companies. Enforcement actions have already begun. SEC claims against Clean Energy Capital, LLC and Camelot Acquisitions Secondary Opportunities Management, LLC, alleging misuse of managed investor funds, are likely early examples of the potentially many cases that will define the boundaries of acceptable investment adviser conduct. Regardless of the extent and scope of the SEC's own enforcement actions, the Dodd-Frank disclosure requirements and the SEC's ongoing investigations may also invite private claims. Actions against the industry are still in their infancy, but now that private equity is less private, some managers may find themselves in the crosshairs of the next wave of regulatory enforcement and claims.

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Securities Litigation and Enforcement

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