

Why PE Clients Must Evolve Their Disclosure Practices

By **Benjamin Horney**

Law360 (July 24, 2019, 7:29 PM EDT) -- The U.S. Securities and Exchange Commission continues to police the private equity industry's disclosure practices, and attorneys must be aware of how the exam environment has evolved while also keeping up to date on emerging tech issues that could cause clients headaches.

Under former SEC chair Mary Jo White, the Division of Enforcement made no effort to hide its crusade against improper practices within the private equity industry, issuing plenty of public guidance and handing out high-profile enforcement actions against major PE shops that totaled millions of dollars in penalties. Although it may appear under current Chairman Jay Clayton that the regulator is no longer eyeing the PE industry with quite the same vigor, attorneys should counsel clients not to get too comfortable.

"I wouldn't call it a subdued enforcement environment," said Michael Wolitzer, a partner at Simpson Thacher & Bartlett LLP and head of the firm's investment funds practice. "It feels more like a normalized environment, where there are regular exams, and there can be problems if there are significant issues, particularly on things the SEC has made clear aren't acceptable. If you have a meaningful problem that is identified during an exam, the SEC is going to seek to peg you for it."

Fee and expense allocation and disclosure are among the major issues that fund managers should already understand will be looked at by the SEC, but PE firms need to realize that there's more to being compliant than simply disclosing more information to investors.

"Now the [private equity] industry has moved forward, and people have disclosure on those issues, so what the SEC is doing is testing practices against that disclosure," said Jason Brown, a partner in the asset management group of Ropes & Gray LLP. "In other words, if your disclosure says that rates will be consistent with the market, the SEC wants to know what diligence you've done to confirm that."

The SEC is not content to take PE players at their word, and today's fund managers must be able to prove that they and their legal counsel have done the work to ensure that what they are saying in disclosure lines up with reality.

"Now it's about understanding what the SEC is looking at and making sure that clients are actually doing the necessary kind of testing themselves," Brown said. "Actually going in and saying, 'Here are the fees and expenses being charged,' lining them up with their disclosure, and doing it all with a fine-toothed comb."

Fees and expenses are just two of many matters the SEC is mandated to oversee; attorneys seeking to become trusted counsel to PE clients should start by studying up on the issues that have been flagged in the past. Those that can do some critical thinking in determining other areas that could be a cause for concern will be seriously sought after, because they'll be able to help clients protect themselves from getting in trouble with regulators.

"As long as firms are disclosing what they need to disclose, making sure they're transparent as can be and following the agreements in place, then those types of issues shouldn't be a problem," said Todd Boudreau, a partner in Morrison & Foerster LLP's private funds group and co-chair of the firm's global private equity investments and buyouts practice. "This can get complicated quickly when you have multiple side letters and funds."

Law firms that lack the resources to handle everything that comes with complicated disclosure practices should consider using a third-party back office administrator to help monitor things like management fee offsets, broken deal fees and allocating cost among funds, Boudreau said. In truth, a PE client's disclosure practices, and its ability to back up the legitimacy of that disclosure, should be plain and clear to the limited partner base. When things become unclear, problems can arise.

"At the end of the day, it's a good idea to take a look at what fees and expenses are being charged and make sure you can line them up with your disclosure," Brown said. "Ask yourself the question the SEC is going to ask: Would a reasonable investor understand that fee or expense was being charged?"

Beyond ensuring firms support their disclosures, attorneys should be cognizant of issues that either recently started to become more common or are likely to be a significant focus of the regulator in the near future.

"Corruption and data security are examples of two topics that are on the top of everyone's mind," said Jay Freedman, a partner at Ropes & Gray. "Additionally, given recent incidents, sexual harassment and other misconduct is something you have to look into when doing deals."

Just knowing that these issues could arise is not enough, however. Attorneys must be comfortable calling on their colleagues when they are facing a matter that requires expertise they themselves may not have. When it comes to corruption, for instance, issues can be difficult to figure out depending on where in the world a portfolio company is based.

"At Ropes & Gray, we do extensive diligence for clients with respect to portfolio companies, or other non-U.S. operations, to help them get comfortable to satisfy obligations under anti-corruption laws," Brown said. "We make a lot of referrals to each other when we come across potential issues," he said.

The modern age has also given rise to one glaring issue that the SEC will probably very much focus on now and in the future: cybersecurity. Today's PE fund managers must take into account how cybersecurity is integrated across all of their offices, as well as at the facilities owned and operated by portfolio companies. While there has not yet been a high-profile penalty due to a cybersecurity breach at a PE shop, an ever-growing reliance on the internet and cloud technologies means the issue is not going away.

"We haven't seen a lot of action on that front, but if the SEC learns of a breach then you'll see a lot of action," Brown said. "I think there will probably be more emphasis going forward on cybersecurity."

--Editing by Brian Baresch and Alanna Weissman.