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KIRKLANDPEN
Private Equity Newsletter

April 16, 2012

SEC Enforcement Eyes Private Equity Fund Managers

PENpoints

The SEC's Enforcement Division has signaled its intent to increase enforcement actions against private equity fund managers.

The Securities and Exchange Commission's (SEC) Division of Enforcement has recently declared that it is setting its sights on the private equity industry and how it raises capital and conducts business. In the past, the Enforcement Division has not scrutinized private equity funds' general business practices. In a recent speech, Robert Kaplan, co-head of the SEC's Asset Management Unit, promised an increase in private equity enforcement actions, noting: "I think private equity law enforcement is where hedge fund law enforcement was five or six years ago."[1] Enforcement actions against hedge fund managers have increased dramatically over the past five years, from relatively few cases in 2005 to over 50 cases in 2011.

The recent focus on private equity corresponds with the Enforcement Division's move towards specialization in certain high priority areas of enforcement.[2] In 2010, the SEC created five specialized enforcement units, the largest of which is the Asset Management Unit, an investigative unit of 65 members specifically focused on bringing cases against investment advisers, investment companies, hedge funds and private equity funds. The Asset Management Unit recently hired experts with private equity and other industry experience. At the SEC Speaks Conference on February 24, 2012, Bruce Karpati, co-head of the Asset Management Unit, lauded the unit's private equity expert as someone who "knows where the skeletons are."

Historically, the SEC enforcement efforts involving private equity managers have concerned "market facing conduct" such as insider trading. The new focus is directed at high-risk areas involving a fund's operations and disclosures to its investors. The identified priorities include:

- Broken-deal expenses and the extent with which fund managers may be disproportionately allocating such expenses to one fund over another when investing side-by-side.

- Management fees charged on so-called underperforming "zombie funds" that live on and are not liquidated so that fund managers can continue to collect management fees.

- Transaction and other fees and whether such fees are fairly determined and adequately disclosed to investors.

- Adequacy of disclosures during the fund formation stage including claims of unrealistic returns based on the track records from predecessor funds.

- Valuation of assets, including the consistency and comparability of a manager's valuation methods and the adequacy of related disclosures to investors.

- Insider trading and the misuse of material, nonpublic information available to fund managers, for example, information obtained through service on a portfolio company's Board of Directors.

- The adequacy of compliance programs, which historically has been dealt with through the routine inspection and examination process but now may be addressed through enforcement actions.

- Potential conflicts of interest arising out of such things as the allocation of co-investment opportunities among clients and whether a fund manager adheres to its fiduciary duties to the fund.

In pursuing these enforcement priorities, the Asset Management Unit has used more proactive approaches

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to identifying potential cases, such as proprietary risk analytics to evaluate fund performance and identify too-good-to-be-true returns (à la Bernie Madoff) indicating potentially fraudulent conduct. In addition, in early December 2011, the Asset Management Unit sent informal inquiry letters to about a dozen private-equity firms seeking general information on various practices and disclosures such as asset valuation, including agreements with outside parties responsible for such valuations.[3] The letters stated that the inquiry should not be construed as an indication of any wrongdoing.

All of the SEC's priorities come on the heels of the Dodd-Frank Act, as newly registered private equity managers prepare for regular inspections and enhanced SEC reporting. The Asset Management Unit and the Office of Compliance Inspections and Examinations (the SEC unit responsible for regular inspections and oversight) have already begun to collaborate on setting priorities, a trend that we expect to continue.

A private fund manager can mitigate the risk of an SEC enforcement action with good compliance practices. Both newly and previously registered firms should maintain a risk assessment analysis and detailed compliance procedures addressing topics such as valuation and performance reporting, allocation of investment opportunities and expenses, personal securities transactions and insider trading, conflict management and other key Investment Advisers Act requirements. In addition, Form ADV Part 2 contains investor disclosure requirements in many of these areas. Because of the SEC's increasing focus on private equity managers, registered adviser principals and compliance staff should regularly review the firm's compliance program and ADV disclosure to ensure, among other things, that the current SEC areas of focus have been adequately addressed.

In this new regulatory environment defined by heightened regulatory oversight, a fund manager should evaluate its compliance procedures and ethics guidelines to ensure that they are reasonably designed to comply with the federal securities laws and consistently applied. In addition, as discussed in an earlier *KirklandPEN*, a fund manager should be familiar with the important initial steps to be taken if and when faced with a subpoena or informal inquiry from the SEC's Enforcement Division.

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1 Laura Kreutzer, *SEC Puts Private Equity Under the Enforcement Microscope*, Wall Street Journal, Deal Journal, Jan. 25, 2012; Pete Brush, *SEC's Kaplan Details Plan to Target Private Equity*, Law 360, Jan. 27, 2012.

2 See "SEC's Division of Enforcement: Changing Landscape for Private Equity," *KirklandPEN* (March 17, 2010), discussing these developments.

3 Gregory Zuckerman, *Private-Equity Fund Faces Inquiry on Valuation*, Wall Street Journal, Feb. 24, 2012.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Robert W. Pommer III
http://www.kirkland.com/rpommer
+1 202-879-5950

Scott A. Moehrke, P.C.
http://www.kirkland.com/smoehrke
+1 312-862-2199

Custom-Made MAEs – Tailoring Your Risk Allocation

PENpoints

While the traditional general MAE structure serves a useful purpose, a more tailored approach may be appropriate in certain transactions, particularly when there is a known risk or contingency.

The Material Adverse Effect, or MAE/MAC, definition — often used to qualify representations and warranties and to condition a buyer's obligation to close — remains among the most hotly contested negotiating points for dealmakers. However, a consistent string of Delaware court cases shows that proving the occurrence of an MAE is extremely difficult. In light of this reality and the ambiguous nature of the standard MAE definition (and exceptions), a private equity buyer concerned about a particular risk should consider a customized approach to risk allocation by either including an objectively verifiable closing condition tied to that risk or providing more tailored specificity around what can, and cannot, be taken into account in determining what constitutes an MAE and/or whether an MAE has occurred.

For example, if a target's business or prospects depend on the development of a key product or a continuing relationship with a significant customer, a private equity buyer should consider seeking an objective closing condition relating to that product or customer rather than relying on a general MAE condition. The parties used such an objective standard in a recent public company transaction in the development stage pharmaceutical space where much of the value of the target business was in a key drug product. There, the buyer would not have been obligated to close if a "Serious Adverse Event" — as defined by the U.S. Food and Drug Administration — occurred in ongoing trials of a key new drug which would impede its development. Because the FDA's "SAE" definition is largely objective (e.g., death, disability or permanent damage to a trial participant), the risk to the buyer of asserting an "SAE" was substantially less than if it were forced to rely upon a standard MAE definition.

In addition, in a transaction where a private equity buyer opts to assume all of the financing risk, it can mitigate that risk with a separate closing condition based on a bright-line financial or performance metric, such as a leverage test or a minimum level of trailing EBITDA. Such an objective condition may provide comfort to a private equity buyer and its debt financing sources that the target will be able to support the intended debt load following the closing, and thus mitigate the risk to the sponsor of a financing failure.

While the traditional general MAE structure serves a useful purpose — more often than not as the groundwork for renegotiation in the event of significant adverse developments — a more nuanced and thoughtful approach may be appropriate in certain transactions, particularly when there is a known risk or contingency. By allocating closing risks more objectively, or at least more clearly, parties can benefit from the resulting enhanced certainty of outcome.[1]

1 For an earlier article generally discussing MAE provisions, see "Revisiting the MAC Clause in Transaction Agreements," co-authored by Kirkland partner Andrew Herman, at the following link: http://apps.americanbar.org/buslaw/blt/content/articles/2010/08/mt0003.shtml

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Daniel E. Wolf
http://www.kirkland.com/dwolf
+1 212-446-4884

David B. Feirstein
http://www.kirkland.com/dfeirstein
+1 212-446-4861

Joshua M. Zachariah
http://www.kirkland.com/jzachariah
+1 212-446-6450

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The North Park University Breakfast Series
University Club of Chicago - Chicago, IL
April 17, 2012

The North Park University Breakfast Series unites Chicago's business community with North Park alumni, faculty, staff and students to network and hear from industry leaders.

Thomas S. Bagley, Founder and Senior Managing Director, Pfingsten Partners, LLC, will be speaking and moderating a panel discussion with Charles K. Huebner and Bruce I. Ettelson on the topic of "What is Private Equity? Is It Good or Bad For the Economy?" For more information click here.

ABA Section of International Law 2012 Spring Meeting
New York, NY
April 17 - 21, 2012

At the ABA Section of International Law's annual spring meeting, Kirkland associate Sergio Urias will participate in a panel discussion, "Latin American Utilities: What Big PE Wants, Big PE Gets," on Tuesday, April 17, 2012. He and his fellow panelists will discuss the ongoing boom of private equity investment in Latin American utilities and other regulated sectors, as well as private equity investment strategies, goals, trends and practical advice about transactions in Brazil, Argentina, Chile, Peru and Colombia (from diligence to post-closing compliance). For more information, click here.

32nd Annual Ray Garrett Jr. Corporate and Securities Law Institute
Chicago, IL
May 3-4, 2012

The Ray Garrett Jr. Corporate and Securities Law Institute is the preeminent securities law conference in the Midwest. It is the only Midwest conference that brings together senior officials from the Securities and Exchange Commission and leading securities practitioners. Kirkland partner R. Scott Falk is the Institute's Chair, and Kirkland partner Keith S. Crow is a member of the Institute's Executive Committee. Kirkland partner Mark Filip will chair a session on "Current Topics in SEC and DOJ Enforcement & Corporate Litigation." For more information, click here.

Chicago
300 North LaSalle
Chicago, IL 60654
+1 (312) 862-2000
+1 (312) 862-2200 fax

Hong Kong
26th Floor
Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
+852-3761-3300
+852-3761-3301 fax

London
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 20 7469 2000
+44 20 7469 2001 fax

Los Angeles
333 South Hope Street
29th Floor
Los Angeles, CA 90071
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich
Maximilianstrasse 11
80539 Munich
Germany
+49 89 2030 6000
+49 89 2030 6100 fax

New York
601 Lexington Avenue
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

Palo Alto
950 Page Mill Road
Palo Alto, CA 94304
+1 (650) 859-7000
+1 (650) 859-7500 fax

San Francisco
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Shanghai
11th Floor, HSBC Building
Shanghai IFC
8 Century Avenue
Pudong New District
Shanghai 200120
P.R. China
+8621 3857 6300
+8621 3857 6301 fax

Washington, D.C.
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, real estate, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named Best M&A Firm in the United States at World Finance's 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 IFLR Americas Awards. Kirkland was also recognized as "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook." Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2010 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009, 2010 and 2011, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
+1 (312) 862-8773