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SEC Enforcement: Investment Write-Downs and Management Fees in Post-Commitment Period

4-Minute Read

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On June 20, 2023, the SEC announced an enforcement settlement with Insight Venture Management, LLC (the "Adviser") (*available here*), a private equity fund sponsor, in which the SEC alleged that the Adviser (i) overcharged management fees during the post-commitment period of certain private funds by applying investment write-downs in a manner inconsistent with the governing documents, and (ii) failed to disclose to investors its criteria for determining permanent write-downs and related conflicts. The Adviser reimbursed applicable funds approximately $4.6 million (with nearly $3.8 million of that reimbursement completed during an examination preceding the enforcement case) in allegedly overcharged management fees and interest to the applicable funds, and agreed to pay a $1.5 million penalty in settlement of the enforcement action.

Why it matters: As explained in the SEC's 2022 and 2023 Examination Priorities Reports (*available here and here*), the SEC remains highly focused on private fund sponsors' valuation policies and practices, particularly as they impact management fee calculations during the post-commitment period. The enforcement action further reflects the recurring theme that public SEC pronouncements regarding focus and risk areas frequently precede enforcement cases. This settlement follows an October 2020 enforcement case (*available here*), in which an exempt reporting adviser failed to reduce management fees for write-downs, and signals the willingness of the SEC to (i) substantively critique the Adviser's valuation-related procedures and criteria for determining whether a permanent write-down had occurred and (ii) pursue enforcement in this area even after the sponsor has reimbursed affected funds to remediate concerns during the SEC examination process.

Summary of the facts:

- As is common for private equity funds, the Adviser's governing documents included a provision that reduced the management fee during the post-commitment period by lowering the management fee base from capital commitments to invested capital (in this case, defined as the acquisition cost of investments).

- Any “permanent impairment” in value of an investment would, for purposes of calculating management fees, further reduce the acquisition cost of such investment, and thereby reduce the management fee received by the Adviser.
    - The Adviser’s governing documents did not define “permanent impairment,” but in practice, the Adviser utilized a four-pronged test[1] for determining whether an investment was “permanently impaired.” These criteria were not disclosed to limited partners.
- The Adviser’s investment strategy included instances where its funds invested at multiple levels of a portfolio company’s capital structure, and the SEC interpreted the funds’ governing documents to require the “permanent impairment” analysis to be performed on an investment-by-investment basis (*i.e.*, at the level of each separate debt or equity interest in a portfolio company) rather than on an aggregate portfolio company basis.
- The SEC took issue with the Adviser’s:
    - (i) application of the “permanent impairment” analysis at the aggregate portfolio company level—when applied on an investment-by-investment basis, as the SEC interpreted the governing documents to require, there were instances in which certain individual portfolio investments in a portfolio company were impaired while other portfolio investments in that same portfolio company were not, which led to an excess of approximately $775,000 in management fees charged that were not previously reimbursed,
    - (ii) failure to disclose to limited partners the potential conflicts of interest related to the Adviser’s use of discretionary criteria for determining “permanent impairment,” which the SEC found to be “narrow” and “subjective,” making them “difficult to satisfy;” and
    - (iii) failure to maintain policies and procedures designed to address such conflicts.

Key takeaways:

- The SEC seems poised for more enforcement cases involving private equity fund sponsors, an area that remains in the focus of Chair Gensler.
- The industry should anticipate additional SEC scrutiny around valuation and write-down practices, potentially including more enforcement activity. To prepare, sponsors should carefully review their calculation methodologies to ensure they are utilizing a consistent approach with respect to write-downs that accords with the specifics of their funds’ governing documents.
    - ***Related questions are frequently a part of the SEC examination process, and we have already seen follow-up inquiries from exam teams that reference the recent enforcement case.***
- In the absence of mitigating disclosure, the SEC appears to disfavor the use of discretionary criteria for determining a permanent write-down, which in this enforcement settlement, the SEC criticized as “narrow,” “subjective” and “difficult to satisfy.”
    - Although it is not entirely clear from the settlement, the SEC does not appear to allege that the Adviser substantively misapplied its own criteria or abused its discretion; instead, the focus was on the lack of disclosure to investors around potential conflicts.
    - During the precedent examination, the Adviser adopted a set of objective criteria for determining permanent impairment; the specifics of these criteria were not described, but the SEC did not seem to take issue with them in the settlement.
    - Where feasible, sponsors should utilize objective criteria for permanent write-down determinations (including by incorporating objective standards in a fund’s governing

[1] The Adviser’s criteria for “permanent impairment” considered whether: (a) the valuation of a portfolio company was currently written down in excess of 50% of the aggregate acquisition cost of the investments; (b) the valuation of a portfolio company had been written down below its aggregate acquisition cost for six consecutive quarters; (c) the write-down was primarily due to the portfolio company’s weakening operating results, as opposed to market conditions, comparable transactions, or valuations of comparable public companies; and (d) the portfolio company would likely need to raise additional capital within the next twelve months.

documents) and build out related disclosures on calculation methodologies in offering materials or limited partner reporting.

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