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RECENT SEC ENFORCEMENT ACTION EVIDENCES INCREASED SCRUTINY OF PERMANENT IMPAIRMENT PRACTICES AND PRIVATE FUNDS GENERALLY

To Our Clients and Friends:

On June 20, 2023 the Securities and Exchange Commission (the "***SEC***" or the "***Commission***") announced the settlement of an enforcement action against Insight Venture Management LLC (d/b/a Insight Partners) ("***Insight***") and published an Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (the "***Order***").[1] In the Order, the SEC found that Insight (1) charged excess management fees to its investors through "inaccurate application of its permanent impairment policy" and (2) failed to disclose a conflict of interest to investors concerning the same policy.[2] This action reflects a growing trend we continue to see in our representation of private fund managers in their routine examinations by the SEC–**direct and explicit inquiry into the decision by a given fund manager to not permanently impair (i.e., "write-down") a given fund asset when such impairment would reduce the basis on which management fees are calculated**. We view this as a clear indication of the Commission's focus on scrutinizing the calculation of management fees, in particular after the termination of the commitment period.

I. Calculation of Management Fees

Insight operated multiple funds (the "***Funds***") whose respective limited partnership agreements ("***LPAs***") required, like many do, that management fees be calculated during the "commitment period" (i.e., the period during which the Funds were permitted to make investments) on the basis of committed capital and during the "post-commitment period" (i.e., the period after the commitment period during which the Funds look to exit investments and realize returns)[3] based on invested capital (i.e., "the acquisition cost of portfolio investments held by the Funds"). Pursuant to the LPAs, when an asset had suffered a "permanent impairment in value" that basis was to be reduced commensurately.[4] **The Commission took issue with Insight's approach to determining whether a permanent impairment had occurred (and whether Insight resultantly calculated management fees on too large a basis)**.

Specifically, the Commission identified three of Insight's practices as problematic:

- *Lack of written criteria in LPA.* Insight did not include any language in the Funds' LPAs indicating how a permanent impairment determination would be made.[5]

- *Subjective evaluation criteria*. In practice, Insight employed a four pronged test to determine whether a permanent impairment was appropriate[6] which included whether: "(a) the valuation

of the Fund's aggregated investments in a portfolio company was currently written down in excess of 50% of the aggregate acquisition cost of the investments; (b) the valuation of the Fund's aggregated investments in 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 or 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."[7]

- *Portfolio Company Level v. Portfolio Investment Level.* The Funds' LPAs included separate definitions for "portfolio company" (i.e., "an entity in which a [p]ortfolio [i]nvestment is made by the [p]artnership directly or through one or more intermediate entities of the [p]artnership") and "portfolio investment" (i.e., "any debt or equity (or debt with equity) investment made by the [p]artnership"). Further, the LPA provision governing permanent impairments indicated that they were to be assessed on a *portfolio investment* level rather than a portfolio company level (*emphasis added*).[8] The Commission took the position that Insight's aforementioned evaluation criteria failed to honor this distinction and instead only analyzed the need for a permanent impairment at the aggregate portfolio company level.[9]

Taken together, the Commission found that these practices caused Insight to fail to permanently impair certain of their Funds' assets to the correct extent. As a result, the Commission determined that Insight failed to adequately reduce the basis upon which post-commitment period management fees were calculated, and overcharged their investors.

II. Conflicts of Interest

In addition to the miscalculation of management fees, the Commission also found that the subjective nature of the criteria Insight used to determine whether a permanent impairment had occurred created a conflict of interest between Insight and its investors. Put differently, because Insight was the party ultimately determining whether to find a permanent impairment had occurred, Insight had the right to reverse any permanent impairment it had previously applied, and finding a permanent impairment had occurred would result in Insight collecting fewer management fees, it should have, at the very least, disclosed the existence of this conflict to its investors.[10]

III. Violations and Penalties

As part of its settlement with the SEC, Insight was ordered to reimburse its investors upwards of $4.6 million, corresponding to excess management fees charged and interest thereon, and was required to pay a civil penalty of an additional $1.5 million. It is also notable that although the Commission acknowledged Insight's prompt remedial efforts (which included mid-exam reimbursement) and cooperation during the course of the investigation, they still decided to proceed with enforcement.

IV. Analysis & Key Takeaways

- When determining whether to find a permanent impairment, fund managers should consider listing the criteria they apply in the operative provisions of their LPA(s). Note also that if this

practice is adopted, it will be imperative that fund managers adhere closely to the criteria included in the LPA.

- Though we expect criteria for finding a permanent impairment will always involve some level of subjectivity, including objective factors to the extent possible and/or involving a third-party valuation professional in the process could provide a meaningful level of enforcement risk mitigation. However, while the Order indicates that Insight did, to the satisfaction of the Commission, subsequently apply more objective criteria when determining the amount of management fees it had overcharged its investors, the Order provides no clear guidance as to what criteria the Commission considers sufficiently objective.

- In addition to common valuation related conflicts of interest disclosed in private placement memoranda and similar disclosure documents, fund managers should consider including explicit disclosure around the conflict of interest inherent in the fund manager deciding whether to permanently impair a fund's assets when such decision would negatively impact the amount of management fees the fund manager would be owed.

V. Conclusion

The SEC's recent settlement of its enforcement action against Insight reflects the overall trend towards increased scrutiny of the private funds industry generally, including pursuant to its increased rulemaking related to the same. More specifically, this emphasis on valuation and write-down practices is in harmony with the Commission's 2023 Examination Priorities Report,[11] as well as other recently settled enforcement actions.[12] We expect this trend to continue.

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[1] Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Release No. 6332 (June 20, 2023), link.

[2] *Id.*, Paragraph 1

[3] *Id.*, Paragraph 11

[4] *Id.*, Paragraph 11

[5] *Id.*, Paragraph 14

[6] We note that the Order did not make it clear whether this four-pronged test was maintained or recorded by Insight in any formal investment or valuation policy, but the Commission did note that "Insight did not adopt or implement written policies or procedures reasonably designed to prevent violations of the Advisers Act relating to the calculation of management fees…" *See Id.*, Paragraph 18.

[7] *Id.*, Paragraph 15

[8] *Id.*, Paragraph 12

[9] *Id.*, Paragraph 16

[10] *Id.*, Paragraph 17

[11] Securities and Exchange Commission, Division of Examinations, 2023 Examination Priorities, link.

[12] *See e.g.*, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Release No. 6104 (Sept. 2, 2022) (Finding that Energy Innovation Capital Management LLC, an exempt reporting adviser, improperly calculated management fees by failing to make adjustments for dispositions of its investments, which included any write-down in value of individual portfolio company securities, when the value of such securities provided the basis on which management fees were calculated, resulting in charging its investors excessive management fees), link; Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, Release No. 5617 (Oct. 22, 2020) (Finding that EDG Management Company, LLC failed to write-down the value of certain of its portfolio securities as required by the applicable LPA, which resulted in overcharging management fees to its investors which were calculated using the value of such portfolio securities as the basis), link.

Should you wish to review how your actual management fee calculations synch up with the mechanics set forth in your limited partnership agreement and disclosure set forth in your private placement memoranda, or if you have any questions about how best to prepare for examination scrutiny related to the same, please contact the Gibson Dunn lawyer with whom you usually work in the firm's Investment Funds practice group, or the following authors:

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