SEC Steps Up Private Funds Enforcement With Insight Partners Fee Calculation Settlement

June 21, 2023

Yesterday, the Securities and Exchange Commission announced a settled enforcement action with Insight Venture Management LLC (d/b/a Insight Partners) (“Insight”). In the Order, the SEC found that (i) Insight charged excess management fees related to permanently impaired investments at the portfolio company level (instead of at the actual investment level) in contravention of relevant fund documents, and (ii) failed to disclose certain conflicts of interest in connection with determining permanent impairments using “subjective” and “difficult to satisfy” criteria.¹ The topic of valuation at the security level as dictated by fund documents was the topic of an enforcement action last year,² and the topic of conflict disclosure with respect to an adviser’s valuation-related methodologies seems to be emerging as a critical focus area for SEC enforcement in the Gensler era.

More broadly, we view this settlement as further evidence of a rising tide of aggressive enforcement scrutiny for the private funds industry, continuing recent trends. Until recently, the SEC’s focus on the private funds industry under Chair Gensler has been largely exhibited through extensive rulemaking.³ But the tide has incrementally been turning, with increasingly active examinations and certain noteworthy Enforcement actions in the private equity and funds space at large over the past year.⁴ And last month, Enforcement Director Grewal commented that private funds are a “substantive priority area” for the Enforcement Division, specifically flagging conflicts of interest and fees and expenses. Such remarks by the SEC often preview what has been in the enforcement pipeline and what is to come—and this settlement certainly seems to be an indicator that the wave of enforcement is starting to come ashore.

¹ See SEC Order (June 20, 2023).

² See SEC Order (September 2, 2022) involving Energy Innovation Capital, an exempt reporting adviser, that found the adviser had inaccurately calculated fees at the portfolio company level instead of at the individual security level, and failed to make certain fee calculation adjustments in connection with write downs, among other things.

³ The SEC’s current rulemaking agenda was described in a recent Simpson Thacher alert.

⁴ For example, the SEC recently settled a valuation case related to inadequate policies and procedures with Sciens Diversified Managers, LLC on May 24, 2021. See SEC Order (May 24, 2023). The SEC Order alleges that Sciens did not have reasonably designed valuation policies and procedures related to valuing certain non-marketable investments (Level 3 investments) held by private funds, including investments that were ultimately written down.
A summary of the settlement is below, followed by some practical observations about what private fund sponsors might want to consider in this active regulatory environment—as the SEC’s sustained focus on the crypto markets may have reached a crescendo with the recent initiative of litigated actions, the private funds industry, in our view, is likely to see increased Enforcement scrutiny.

**Case Summary**

Insight’s private equity funds typically invest in technology and related industries. Pursuant to the partnership agreements for its private equity funds, Insight charged post-commitment (i.e., post-investment) period management fees on the basis of investors’ invested capital in the relevant fund, calculated at cost. Under the partnership agreements, the cost basis of investments would be reduced for investments that had been subject to a permanent impairment, with such reduction in value reducing the management fee base for the relevant fund. Permanent impairments were to be determined based on the value of each portfolio investment (i.e., particular investments, such as debt or equity; in the case of partial dispositions, the portion disposed of and the retained portion are deemed to be separate investments) and not at the aggregate portfolio company level. The Order found that Insight applied the impairment analysis at the portfolio company level rather than the portfolio investment level, as prescribed by the partnership agreements, which resulted in overcharging management fees as certain portfolio investments in portfolio companies were impaired according to the criteria, even if the overall portfolio company (taken as a whole) was not.

Insight used a four factor test to determine permanent impairments, which assessed whether an investment was (i) written down 50% or more in value, (ii) valued below cost for 6 consecutive quarters, (iii) written down primarily due to operating results as opposed to due to market conditions or comparable transactions or companies (the latter suggesting an impairment was not permanent) and (iv) likely to need additional capital raised in the next 12 months. Insight also had discretion to reverse permanent impairment decisions under the partnership agreements. The Order found that Insight had failed to adequately disclose to limited partners the existence of conflicts of interest in connection with determining whether a permanent impairment had occurred based on the factors above, given that, per the SEC, Insight applied “narrow,” “subjective” and “difficult to satisfy” permanent criteria. In connection with these findings, the SEC also concluded that Insight had not adopted adequate policies and procedures related to its permanent impairment criteria, their impact on management fees and related conflicts of interest.

The Order noted that, during the course of the examination, Insight adopted and disclosed new and more “objective” impairment criteria and also waived its ability to reverse permanent impairments. Insight reimbursed limited partners $3.8 million, as calculated by applying its more objective criteria to management fees associated with four portfolio companies plus interest. Subsequently during the investigation, Insight applied its prior (and

---

5 During the commitment (i.e., investment) period, management fees were charged on capital commitments (not invested amounts).
less objective, in the eyes of the SEC) policy at the investment level across all funds and reimbursed a resultant $865k in management fees plus interest.

The SEC found Insight violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder and ordered disgorgement of approximately $865k that was previously reimbursed and thus deemed satisfied. Insight was also ordered to pay a civil monetary penalty of $1.5 million.

**Takeaways**

- The SEC has been, and continues to be, extremely focused on management fee calculations. The referenced Energy Innovation Capital settlement (on investment level valuations; and on write downs) and this settlement (on investment level valuations; and regarding permanent impairments) afford notice to advisers of some of the SEC’s key focus areas pertaining to fees.

- Areas with greater potential for conflicts of interest between sponsors and investors (such as fee calculations) will continue to be a focus for examiners and enforcement staff and expectations will remain high for sponsors to have disclosures specifically stating material conflicts that are sufficiently clear for limited partners to understand—for example, potentially including disclosure that such criteria could be applied in the sponsor’s discretion and incorporate subjective factors (if applicable).

  - Relatedly, advisers should ensure their policies, procedures and practices are designed to address these conflicts in a tailored and objective manner.

- Reimbursement during examinations and/or investigations is often a powerful tool to help mitigate the risk of a referral to SEC Enforcement or ultimate Enforcement action—but this settlement seems to suggest the limits of reimbursement as a mitigating factor where the staff may view a reimbursement as insufficient or potentially too late. When issues are uncovered, reimbursing on a fulsome basis and as early as possible (ideally before the SEC begins to inquire) will, we believe, tend to mitigate the outcome of the inquiry.

- Advisers should review their valuation criteria and consider if the criteria used to determine whether an impairment or other change in the value of investments, particularly where affecting fees paid by investors, could be enhanced to be more objective (where possible).

- Advisers should consider evaluating their existing disclosures, offering documents and other reporting to ensure that criteria are consistently and accurately applied.

  - For instance, and importantly, sponsors should evaluate how (and at which level, in particular) they are required to assess impairments related to investments.