HUNTON& WILLIAMS

Client Alert

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SEC Continues Scrutiny of Fee and Expense Practices in Private Equity Industry

The U.S. Securities and Exchange Commission ("SEC") has been increasingly focused on the fee and expense practices of the private equity industry over the past several years. With two high-profile enforcement actions in the last six months resulting in meaningful settlements, that focus appears to be transitioning from policy speeches and examination priorities to enforcement discussions and proceedings. This alert follows the SEC's scrutiny of private equity fees and expenses, examines four enforcement actions in that area over the last two years and questions whether these enforcement actions represent a shift in the SEC's approach to regulation of the private equity industry from one of collaborative examination in an effort to prompt forward-looking change to one of enforcement.

SEC Examination Initiatives

In response to the registration of a number of private equity firms with the SEC following the passage of the Dodd-Frank Act,[1] the SEC's Office of Compliance Inspections and Examinations ("OCIE") commenced a Presence Exam Initiative ("Initiative") in October of 2012. The Initiative represented an effort by the SEC to better understand the private equity industry and its practices as well as to assess the issues and risks presented by those practices.

In a speech delivered by Andrew J. Bowden on May 6, 2014 (while Mr. Bowden was Director of OCIE), Mr. Bowden reported that through the Initiative, the SEC had examined more than 150 newly registered private fund advisers.[2] In addition to discussing various other violations of law or material weaknesses in compliance policies and procedures discovered in the Initiative, Mr. Bowden noted that when OCIE examined how fees and expenses were handled by private equity firms, it identified violations of law or material weaknesses in compliance control in over 50 percent of the firms that were examined. Following this finding, OCIE made clear that private equity fees and expenses would be a priority for its review in 2015.[3] Since that time, many private equity sponsors have seen fees, expenses and similar issues occupy OCIE's time and attention during examinations.

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[1] According to data published by the SEC's Division of Investment Management, as of January 1, 2013, there were 4,020 private fund advisers registered with the SEC, of which 1,521 (approximately 38 percent) registered following the effective date of Dodd-Frank in July of 2011. The data is available at http://www.sec.gov/divisions/investment/imissues/df-iaregistration.pdf. We would estimate that a significant portion of the previously registered private fund advisers registered in 2010 and early 2011.

[2] "*Spreading Sunshine in Private Equity"* by Andrew J. Bowden, Director OCIE at Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014).

[3] OCIE "Examination Priorities for 2015," National Examination Program, Office of Compliance Inspections and Examinations (January 13, 2015).

Recent Enforcement Actions

In addition to the ongoing examination initiatives undertaken by OCIE, the SEC has brought a series of enforcement actions over the past two years related to fee and expense practices of private equity firms.

Clean Energy and Lincolnshire

On February 25, 2014, the SEC instituted its first action arising from private equity fees and expenses in its enforcement proceeding against Clean Energy Capital, LLC, a Tucson-based private equity firm ("Clean Energy").[4] The SEC alleged that Clean Energy had improperly charged expenses (employee salaries, executive bonuses, health benefits, retirement benefits and rent) to its funds instead of the management company. Clean Energy agreed to a cease-and-desist order and to pay approximately $2.2 million to settle with the SEC.[5]

Following the Clean Energy case, the SEC announced on September 22, 2014 that it had charged Lincolnshire Management Inc., a New York-based private equity firm ("Lincolnshire"), with the misallocation of expenses (administration expenses, employee salaries, overhead costs and executive bonuses) between two portfolio companies in a manner that improperly benefited one of its funds at the expense of another.[6] The SEC also found that Lincolnshire failed to adopt and implement policies and procedures related to the allocation of portfolio company expenses. Without admitting or denying the findings, Lincolnshire agreed to a cease-and-desist order and to pay over $2.3 million to settle with the SEC.

KKR

In June of 2015 the SEC settled administrative proceedings against Kohlberg Kravis Roberts & Co. L.P. ("KKR") alleging the improper allocation of broken-deal expenses.[7] According to the SEC, KKR allegedly misallocated more than $17 million in broken-deal expenses to its private equity funds without allocating any of those expenses to the funds' co-investors (including investment vehicles established for KKR affiliates and investment vehicles for third-party investors). While the fund operating agreements did require the funds to pay "all" broken-deal expenses, the SEC found that KKR (i) failed to adopt compliance policies and procedures for the allocation of broken-deal expenses prior to 2011 (the SEC noted that KKR had subsequently adopted a policy in 2012) and (ii) failed to adequately disclose to fund investors that broken-deal expenses would not be allocated to co-investors even though the co-investors benefited from KKR's general sourcing of transactions. KKR agreed to settle with the SEC and pay nearly $30 million. In accepting the settlement, the SEC noted the remedial action taken by KKR prior to examination as well as the cooperation afforded by KKR to SEC staff during the examination and investigation.

Blackstone

On October 7, 2015, the SEC alleged that three of Blackstone's private equity fund advisers (i) failed to adequately disclose the acceleration of monitoring fees paid by fund-owned portfolio companies prior to the companies' sale or initial public offering and (ii) did not inform fund investors about a separate fee

[4] *In the Matter of Clean Energy Capital LLC et al.*, SEC Release No. 33-9551 (February 5, 2014).

[5] *In the Matter of Clean Energy Capital LLC et al.*, SEC Release No. 33-9667 (October 17, 2014).

[6] *In the Matter of Lincolnshire Management Inc.*, SEC Release No. IA-3927 (September 22, 2014).

[7] *In the Matter of Kohlberg Kravis Roberts & Co. L.P.*, SEC Release No. IA-4131 (June 29, 2015).

arrangement that provided Blackstone with a much greater discount on services by an outside law firm than the discount that the law firm provided to the funds.[8]

The bulk of the SEC's order focused on Blackstone's practice of receiving certain monitoring fees from portfolio companies owned by Blackstone's private equity funds. According to the SEC's order, Blackstone typically charged a monitoring fee to each portfolio company that covered advisory and consulting services to such portfolio company and typically ran for a set term (often 10 years). While the SEC acknowledged that each fund's offering and operating documents disclosed Blackstone's potential receipt of monitoring fees (and, in some cases, provided up to a 50 percent offset against management fees for monitoring fees received from portfolio companies), the SEC alleged (i) that Blackstone failed to disclose to fund investors that the monitoring agreements provided for the acceleration of monitoring fees to be triggered by certain events (including the sale or initial public offering of the portfolio company) and (ii) for a period of six years from 2010 to 2015, Blackstone accelerated certain monitoring fees upon the termination of the applicable agreements with the portfolio companies, including in circumstances where funds had completely disposed of their interests in portfolio companies.

In addition to the monitoring fee issue, the SEC also alleged that Blackstone had failed to disclose to fund investors a legal fee arrangement that provided Blackstone with a greater discount on its legal fees than the discount the funds received. According to the SEC, Blackstone negotiated a discounted legal rate with its primary outside counsel in 2007 that provided disparate legal fee discounts between Blackstone and the funds. The SEC further alleged that Blackstone did not disclose this disparate legal fee arrangement to fund investors from 2008 through early 2011. The SEC did note that (i) in 2011, Blackstone voluntarily ended this arrangement and adopted a new services arrangement that provided the same discount to Blackstone and the funds and (ii) in 2012, Blackstone disclosed to all fund investors the disparate fee arrangement that had been in place from 2007 to 2011.

As a result of the alleged failure to adequately disclose the monitoring fee acceleration and arrangement for disparate legal fee discounts, the SEC found that Blackstone had breached its fiduciary duty to the funds in violation of Sections 206(2) and 206(4) and Rule 206(4)-8 of the Investment Advisers Act of 1940 (the "Advisers Act") as well as Rule 206(4)-8 thereunder. In addition, the SEC found that Blackstone had failed to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act in violation of Rule 206(4)-7 under the Advisers Act. Blackstone agreed to settle with the SEC and pay nearly $39 million. Similar to the KKR settlement, the SEC cited the remedial action taken by Blackstone prior to examination as well as the cooperation afforded by Blackstone to the SEC in mitigating but not eliminated the need for fines and penalties.

Shift in Focus

These enforcement actions may suggest a shift in the SEC's approach to regulating investment advisers to private equity funds. Since the wave of registrations by private equity firms in 2010-2012, the SEC has been focused on gaining a better understanding of the private equity industry and how it should apply Advisers Act principles to the private equity model. Prior to that time, the Advisers Act had not been extensively applied to the private equity model of closed-end funds buying and selling large stakes in operating businesses. In our experience, most OCIE examinations have reflected a collaborative process focused on both the SEC and the manager gaining a better understanding of the compliance elements evolving in the private equity industry. Often, these examinations have resulted in constructive, forward-looking changes to a private equity firm's compliance and/or disclosure regime.

Now, with this line of enforcement actions, we see the SEC imposing current, more enlightened thinking about the application of the Advisers Act to practices that predate the SEC's and the industry's joint

[8] *In the Matter of Blackstone Management Partners L.L.C. et al.*, SEC Release No. IA-4219 (October 7, 2015).

ascension of their mutual learning curve. As highlighted by the Blackstone and KKR enforcement actions, this is even the case where private equity firms had, as part of their self-examination and education, identified prior practices as potentially inconsistent with the new regulatory regime and initiated corrective action prior to SEC examination.

Finally, these actions suggested a heightened focus on detailed disclosures about private equity fee and expense practices (e.g., disclosure of monitoring fees, partial offset of same but no disclosure of acceleration provisions). In that focus, it remains to be seen what weight, if any, is given to the due diligence practices and discoveries of many private equity investors. Should fund managers be held to a “retail” or small investor style of disclosure regarding their practices with investors that expend considerable internal and external resources on thorough due diligence? It doesn’t appear that the SEC took that into consideration in these actions.

In light of these actions, private equity managers may want to think about their expense and fee practices and disclosures relating thereto. Changes or tweaks made now, as opposed to waiting until the next fund launch, could avoid the next OCIE examination expanding to an enforcement discussion, or mitigate potential fines and penalties.

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