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The Drumbeat Continues: SEC Foreshadows Continuing and Increased Scrutiny for Private Equity

Andrew Ceresney, Director of the U.S. Securities and Exchange Commission's ("SEC") Division of Enforcement ("Enforcement"), has warned that the regulator's current focus on private equity funds will continue and that it is seeking to "aggressively bring impactful cases." We recommend that private equity fund sponsors review their activities and disclosure practices with a particular focus on activities that the SEC has targeted and may target in the future in light of its stated objective.

In a speech (available here) delivered this month, Mr. Ceresney said that recent SEC actions against private equity firms should "send a clear signal to industry participants that their practices must comport with their fiduciary duty and disclosures in their fund organizational documents." Mr. Ceresney noted that the SEC's efforts against private equity have "expanded significantly over the past three years," and he discussed the SEC's enforcement focus, problematic conduct the SEC believes it has uncovered, defenses the SEC has rejected, and positive industry changes the SEC believes have been instituted in response to recent enforcement activities.

1. Why the SEC is Focused on Private Equity

Mr. Ceresney cited several reasons to justify the ongoing regulatory scrutiny being applied to private equity funds:

1.1 The structure and investment programs of private equity funds typically require that investors make long-term capital commitments, enter into up-front agreements governing the terms of their investments throughout a fund's life, and cannot easily withdraw their capital or otherwise discontinue participation in a fund when issues arise. Therefore, Mr. Ceresney indicated, "[i]t is . . . critically important that advisers disclose all material information, including conflicts of interest, to investors at the time their capital is committed."

Contents

1.2 The majority of private equity funds have a Limited Partner Advisory Committee ("LPAC")—typically made up of sophisticated investors who are unaffiliated with the adviser—that is "sometimes explicitly tasked with reviewing conflicts of interest by the fund's formation documents." The SEC has found that some private equity fund advisers "have failed to provide the LPAC members with sufficient disclosures to make such determinations." The SEC has observed that "sometimes fees are not properly disclosed, conflicts are not aired, expenses are misallocated, and investors are defrauded."

1.3 Non-institutional and other less sophisticated constituencies often have indirect exposure to private equity funds through public and private pension plans, for example. If an adviser engages in fraudulent conduct that adversely affects a private equity fund, the SEC makes the case that "the underlying victims frequently include retail investors, who in many cases are not in a position to protect themselves." Moreover, the SEC takes the view that even sophisticated investors can be defrauded where private equity funds "lack transparency into the various fees, expenses, and practices—which has been the case in the past." Accordingly, Mr. Ceresney argued, there is "little question that private equity is an appropriate focus for the SEC."

2. Problematic Conduct that the SEC Claims to Have Uncovered Through its Enforcement Actions

In October 2012, the SEC's Office of Compliance Inspection and Examinations ("OCIE") launched its "Presence Exam Initiative," which examined many private equity advisers and identified numerous alleged deficiencies. In 2014, OCIE publicly identified several industry practices observed during these examinations, and noted that "over fifty percent of the examined private equity fund advisers had compliance issues."[1] Mr. Ceresney noted that Enforcement's Asset Management Unit has now brought eight enforcement actions relating to private equity advisers, and he promised "more to come." While the SEC has not indicated with specificity the types of conduct that it will seek to target in the future, it is instructive to review the prior categories of industry conduct that the SEC has identified as problematic and which have generated enforcement actions. These actions have generally related to the three categories of conduct discussed below.

2.1 Undisclosed Fees and Expenses

In 2015, the SEC charged three private equity advisers in the Blackstone Group for two separate alleged breaches of fiduciary duty. Blackstone

1 Andrew J. Bowden, Director of OCIE, "Spreading Sunshine in Private Equity," (May 4, 2014), available at https://www.sec.gov/news/speech/2014--spch05062014ab.html.

paid approximately $39 million to settle the matter.[2] It did not admit or deny the SEC's allegations, and the SEC did not prove them before a court or administrative law judge.

The first alleged issue related to monitoring agreements between Blackstone and its portfolio companies. Private equity fund advisers often enter into agreements with portfolio companies of their funds to provide monitoring services. These agreements frequently provide that, upon the company's IPO or sale, any remaining payments for monitoring services due under the agreement can be accelerated. The adviser in those circumstances may receive the net present value of those fees, which the SEC alleges "is often substantial and is not the customary monitoring fee to which the parties agreed in the fund organizational documents." While Blackstone's funds disclosed in their offering documents that Blackstone may receive monitoring fees from portfolio companies, they allegedly did not disclose the related acceleration provisions. When Blackstone received accelerated monitoring fee payments in connection with the sale or IPO of its portfolio companies, the SEC claimed that acceleration served to essentially "[reduce] the value of the portfolio companies prior to sale, to the detriment of the funds and their investors."[3]

The SEC claimed that because private equity fund investors do not typically have access to the agreements between advisers and their portfolio companies, "they are often unaware of such payments and their terms, and therefore the adviser's ability to collect this accelerated fee should be disclosed to investors at the time they commit capital."

The second alleged issue related to Blackstone's negotiation of a single legal services arrangement with an outside law firm on behalf of itself and its funds. Under the agreement, Blackstone itself received a substantially greater discount in connection with fees for similar legal services than did the funds advised by Blackstone, notwithstanding that the funds generated considerably more legal fees in the aggregate than did Blackstone. According to the SEC, Blackstone "breached its fiduciary duty by securing greater benefits for itself than the funds it advised" without disclosing that benefit to the funds, the funds' LPACs, or the funds' investors to obtain their consent.

The SEC again emphasized in this context that "full transparency of fees and conflicts of interest is critical in the private equity industry."

2 U.S. Securities and Exchange Commission, Press Release 2015-235, "Blackstone Charged With Disclosure Failures" (Oct. 7, 2015), available at https://www.sec.gov/news/pressrelease/2015-235.html.

3 *See In the Matter of Blackstone Management Partners, L.L.C., et al.*, Advisers Act Release No. 4219 (Oct. 7, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4219.pdf.

2.2 Expense Allocation The SEC has also focused enforcement actions on the manner in which expenses are allocated by private equity fund managers across various funds and vehicles.

In June 2015, the SEC charged KKR with misallocating "broken deal" expenses from aborted transactions.[4] Specifically, the SEC took issue with the practice of allocating broken deal expenses to the primary funds which would have consummated the relevant transaction and not to its separate accounts or its own investment vehicles that often invested alongside such funds.[5] The SEC found that KKR funds did not properly disclose in their offering materials that the flagship funds would pay for all broken deal expenses, which the SEC found to constitute a breach of fiduciary duty. KKR ultimately agreed to pay approximately $30 million to settle the matter.[6] KKR did not admit the allegations, and the SEC did not prove the allegations in court or any other administrative court.

In 2014, the SEC charged Lincolnshire Management for misallocating expenses between two portfolio companies.[7] Lincolnshire managed two portfolio companies as one, and allegedly breached its fiduciary duty by causing one of the two companies to pay more than its share of the companies' joint expenses. An adviser that manages multiple funds and engages in transactions across those funds, Mr. Ceresney claimed, "must be mindful of the fact that it owes a separate fiduciary duty to each fund, and must ensure that its actions do not fraudulently benefit one fund at the expense of another."

Finally, the SEC charged two Cherokee private equity fund advisers for misallocating their own consulting, legal, and compliance expenses to their fund clients.[8] Because the funds' organizational documents did not provide for such allocation, the advisers ultimately reimbursed the funds and paid a $100,000 penalty.

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[4] "Broken deal" expenses refer to the legal and other expenses associated with a transaction that is not consummated. Funds often bear these expenses, which can be significant, particularly in the aggregate over the life of a fund. Where it is expected that separate accounts, "friends and family" vehicles, third party co-investors or other participants will invest alongside an adviser's funds, the SEC states that "it is important for advisers to ensure that the costs of each potential investment are paid by those that might benefit from that potential investment's return" or for the adviser to disclose otherwise.

[5] *In the Matter of Kohlberg Kravis Roberts & Co., L.P.*, Advisers Act Release No. 4131 (June 29, 2015), available at: https://www.sec.gov/news/speech/private-equity-enforcement.html.

[6] According to the SEC, KKR violated Section 206(2) of the Advisers Act, which prohibits investment advisers from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." A violation of Section 206(2) can be supported by a showing of simple negligence; proof of scienter is not required. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

[7] *In the Matter of Lincolnshire Management, Inc*., Advisers Act Release No. 3927 (Sept. 22, 2014), available at: https://www.sec.gov/litigation/admin/2014/ia-3927.pdf. Lincolnshire did not admit or deny liability, and settled without requiring the SEC to prove its allegations in court or before an administrative judge.

[8] *In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC*, Advisers Act Release No. 4258 (Nov. 5, 2015), available at: https://www.sec.gov/litigation/admin/2015/ia-4258.pdf. Cherokee did not admit liability, and the SEC did not prove the allegations in court.

2.3 Undisclosed Conflicts of Interest Finally, Mr. Ceresney discussed two cases involving failures to disclose conflicts of interest.

In the first case, the SEC charged Fenway Partners and four of its executives with three separate alleged failures to disclose conflicts: (1) allegedly to avoid having monitoring fees, paid by portfolio companies, be offset against the fund's management fee, Fenway Partners directed the portfolio companies to enter into consulting agreements with an affiliate to provide the same monitoring services (with the same employees) but without the offset; (2) Fenway Partners sought $4 million from investors in connection with investment in a portfolio company without disclosing that $1 million of that investment would be paid to a Fenway Partners affiliate; and (3) Fenway Partners caused three of its former employees to receive $15 million from a portfolio company for services rendered almost entirely while they were employed at Fenway without disclosing the conflict. Without admitting liability, the parties eventually agreed to pay approximately $10.2 million into a fund for harmed investors to settle with the SEC.[9]

Finally, the SEC charged JH Partners with failing to disclose and obtain consent for a series of loans to the funds' portfolio companies that led to the advisers obtaining interests in the portfolio companies senior to those held by the funds themselves; causing funds to invest in the same companies at different priority levels "potentially favoring one client over another;" and causing the funds' investments to exceed the concentration limits contained in their governing documents. Without admitting liability or requiring the SEC to prove its case in court, JH Partners settled with the SEC by agreeing to a cease and desist order and a $225,000 penalty.[10]

3. The SEC's Response to Certain Defenses

Mr. Ceresney discussed three arguments raised by private equity fund sponsors in connection with allegations by the SEC of improper conduct that the SEC has not found persuasive:

3.1 Advisers have argued that it is unfair to bring actions against advisers on the basis of a failure to disclose facts or conduct in fund offering documents that were drafted before the SEC began its focus on private equity funds and, in some cases, before the relevant adviser was required to register as an investment adviser with the SEC. Mr. Ceresney brushed this argument aside by noting that, "although private equity fund advisers

[9] *In the Matter of Fenway Partners, LLC, et al*., Advisers Act Release No. 4253 (Nov. 3, 2015), available at: https://www.sec.gov/litigation/admin/2015/ia-4253.pdf. As with the other cases, Fenway Partners and its charged executives did not admit the SEC's allegations, and they settled without requiring the SEC to prove its case in court.

[10] *In the Matter of JH Partners, LLC*, Advisers Act Release No. 4276 (Nov. 23, 2015), available at: https://www.sec.gov/litigation/admin/2015/ia-4276.pdf.

typically did not register until after Dodd-Frank was enacted, they have always been investment advisers and subject to certain provisions of the Investment Advisers Act. All investment advisers, whether registered or not, are fiduciaries and are subject to the Advisers Act antifraud provisions."

3.2 Other advisers have argued that investors benefited from the services that allegedly constituted a conflict of interest, notwithstanding any failure to disclose the relevant conflict. Mr. Ceresney noted that this may be relevant to the consideration of potential remedies, but that whether or not an investor benefitted from the relevant activity makes no difference when it comes to liability. "As a fiduciary, an investment adviser is required to disclose all material conflicts of interest so that the client can evaluate the conflict itself."

3.3 Finally, some advisers have argued that the relevant conduct called into question by the SEC was undertaken in a manner consistent with the advice of counsel. Mr. Ceresney stated that, if the adviser waives privilege and completely discloses the relevant advice to the regulator, then "[the SEC] will consider this advice in evaluating the appropriateness of an action and the remedies we will seek." Nevertheless, Mr. Ceresney continued, "the adviser is still ultimately responsible for its conduct—including its disclosures of conflicts to its clients—and cannot escape liability simply by pointing to the actions of counsel."

4. Positive Impacts Cited by the SEC

According to Mr. Ceresney, the SEC's focus on private equity funds has helped "significantly increase" transparency and has "prompted real change for the benefit of investors." Since 2014, Mr. Ceresney noted, many advisers have revised their Form ADV filings "to more fully disclose their fee and expense practices." Further, "certain private equity advisers have taken affirmative steps to change their fee and expense practices and bring them in line with their organizational documents." Mr. Ceresney stated his hope "that these actions will lead other advisers . . . to proactively change their practices to seek to avoid conflicts of interest with clients and to ensure, at a minimum, that they are in line with their organizational documents."

As noted above, the SEC's continued focus on private equity funds is only likely to increase in the near term, and fund sponsors should review their operations in that light. Among other things, private equity fund sponsors should:

> carefully review offering materials, limited partnership agreements, other organizational documents, as well as LPAC and investor disclosures to evaluate whether the specific categories of conduct on which the SEC has focused in recent enforcement actions are fully disclosed and accurately reflect the sponsor's actual practices;

> review other forms of conduct as between the sponsor and its clients (i.e., the funds, vehicles and accounts it advises) and among its clients that may involve conflicts of interest or variation of treatment and to fully and accurately disclose these practices to new and existing clients;
> periodically take stock of new activities and lines of business that the sponsor and its affiliates enter into in order to identify whether new issues have arisen or may arise that should be disclosed to new and existing investors; and
> ensure that the sponsor has policies and procedures in place that are designed ensure that the sponsor conducts its activities vis-à-vis its clients in a manner consistent with its disclosures and its fiduciary duties to its clients.

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