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CLIENT MEMORANDUM

SEC Brings Additional Enforcement Actions Related to Private Equity Fees and Expenses

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In two recent enforcement actions, the Securities and Exchange Commission (the "SEC" or "Commission") continued to shine its regulatory spotlight on private equity fund fees and expenses. The Commission's case against Fenway Partners, LLC ("Fenway Partners") and four of its executives centered on consulting fees paid by a private equity fund to a Fenway Partners affiliate. The action against Cherokee Investment Partners, LLC and Cherokee Advisers, LLC involved alleged improper allocation of consulting, legal and compliance-related expenses. Taken together, the two cases emphasize the importance for private equity fund managers to identify potential conflicts of interest built into their businesses and to disclose the conflicts clearly to fund investors.

On November 3, 2015, the SEC charged Fenway Partners and four of its executives with failing to disclose to a private equity fund and its investors certain conflicts of interest relating to monitoring fees paid by the fund to a Fenway Partners affiliated entity and incentive compensation paid upon a portfolio company exit with respect to Fenway Partners employees. In settling the SEC's action, Fenway Partners and the four executives agreed to pay more than $10 million, including disgorgement with interest and a $1.525 million penalty.[1]

[1] Fenway Partners and the executives named in the enforcement action neither admitted nor denied the SEC's findings. *See* SEC Press Release, "SEC Charges Private Equity Firm and Four Executives With Failing to Disclose Conflicts of Interest," *available* here.

At the center of the Fenway Partners action were certain Management Services Agreements into which Fenway Partners had entered with portfolio companies held by a private equity fund for which Fenway Partners served as the investment adviser. According to the SEC, the portfolio companies paid monitoring fees to Fenway Partners for rendering management and other services; the fund's organizational documents provided for an offset of 80% of such fees against the management fee paid to Fenway Partners by the private equity fund. The SEC alleged that, beginning in December 2011, Fenway Partners and its executives caused portfolio companies to end their payment obligations to Fenway Partners and enter into new agreements with Fenway Consulting Partners, LLC ("Fenway Consulting"), an entity affiliated with Fenway Partners and principally owned and operated by three of its executives. According to the SEC, under these new agreements, Fenway Consulting provided services that were similar to those provided under the original agreements and often used the same employees; however, the fees paid to Fenway Consulting (totaling $5.74 million) were not offset against the management fee that the fund paid to Fenway Partners. The SEC alleged that Fenway Partners did not disclose the conflicts of interest caused by rerouting these fees to an affiliate and adopting payment agreements without the benefit of a management fee offset. Press accounts, but not the SEC order, suggest that the performance of Fenway Partners was challenged throughout this timeframe.

The SEC highlighted two other instances in which Fenway Partners and its executives failed to disclose conflicts of interest related to fees and expenses. One related to the conflict of interest caused when Fenway Partners asked investors in a private equity fund advised by Fenway Partners to provide $4 million in connection with an investment in a portfolio company without disclosing that $1 million of the investment would be used to pay Fenway Consulting. Another related to incentive compensation that one of the executives and two former Fenway Partners employees received when the private equity fund exited a portfolio company. The SEC noted that this compensation was provided for services that were almost entirely performed while the individuals were Fenway Partners employees. According to the SEC, the individuals receiving these payments, which totaled $15 million, were employees of Fenway Consulting at the time the payments were made. The SEC alleged that Fenway Partners and its executives did not disclose the conflict of interest triggered by these payments to the private equity fund's advisory board or its limited partners, and that they also failed to disclose these payments as related party transactions in their financial statements provided to investors.

It is notable that certain conduct forming the basis for the violations detailed in the settled order occurred before Fenway Partners became registered as an investment adviser with the SEC in March 2012, underscoring an SEC position that the relevant violations of the Investment Advisers Act of 1940 (the "Advisers Act") apply to all investment advisers, not just those registered with the SEC. The SEC concluded that Fenway Partners and three of its executives failed to adequately disclose these conflicts of interest and violated, and one executive caused violations of, Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The SEC also concluded that Fenway Partners and three of its executives violated, and one executive caused violations of, Section 206(4) of, and Rule 206(4)-8 under, the Advisers Act, which prohibit any fraudulent, deceptive or manipulative act, practice, or course of business by an investment adviser to an investor or prospective investor in a pooled investment vehicle.

Upon the announcement of the settlement, Andrew Ceresney, the Director of the SEC's Division of Enforcement, noted that "[p]rivate equity advisers must be particularly vigilant about conflicts of interest and disclosure when entering into arrangements with affiliates that benefit them at the expense of their fund clients or when receiving payments from portfolio companies."

On November 5, 2015, the SEC settled a separate enforcement action against private equity fund advisers Cherokee Investment Partners, LLC and Cherokee Advisers, LLC for allegedly improperly allocating consulting, legal, and compliance-related expenses to their funds.[2] The SEC alleged that the adviser entities caused their funds to pay for expenses related to the firm's registration as an investment adviser under the Advisers Act, expenses related to a third-party compliance consultant and expenses related to responses to the SEC exam staff and SEC enforcement staff. According to the SEC, while the funds' organizational documents disclosed that the funds would bear expenses arising out of the operation and activities of the funds, the documents did not indicate that the funds would be charged for the advisers' legal and compliance expenses. The advisers had already voluntarily reimbursed the funds in the amount of $455,698, the full amount of the expenses, and were assessed a $100,000 fine.

These two matters add to the growing list of SEC settlements concerning the allocation of fees and expenses by private equity managers. We expect that the SEC — both the Office of Compliance Inspections and Examinations (OCIE) and the Division of Enforcement — will continue to scrutinize payments to private equity and other private fund managers and their employees that involve potential conflicts of interest and issues of inadequate disclosure. These settlements suggest that private equity managers should continue to review and update the disclosures found in their funds' offering and governing documents while remaining cognizant of specifically disclosing any potential conflicts.

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[2] Cherokee Investment Partners, LLC and Cherokee Advisers, LLC neither admitted nor denied the SEC's findings. *See* Advisers Act Release No. 4,258, *available* here.