CLIENT MEMORANDUM

SEC Settlement with a Private Equity Firm Relating to Acceleration of Monitoring Fees, Reporting of Affiliate Loan and Expense Reimbursement Practices

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In the latest of a number of enforcement proceedings initiated against private equity firms regarding fees and expenses,[1] the U.S. Securities and Exchange Commission (the "SEC"), on August 23, 2016, announced a settlement with four New York-based private equity fund advisers (collectively, "Apollo") affiliated with Apollo Global Management, LLC.[2] In a press release announcing the settlement, Andrew Ceresney, the Director of the SEC's Division of Enforcement, said that a "common theme in our recent enforcement actions against private equity firms is their failure to properly disclose fees and conflicts of interest to fund investors."[3]

Three separate sets of facts underlaid the SEC's action. In particular, the SEC alleged that Apollo failed to:

i. adequately disclose that it may accelerate the payment of future monitoring fees;

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1 *See SEC Enforcement Director Reviews Focus on Private Equity*, WFG Client Memorandum (May 16, 2016) *available* here.

2 *See Apollo Management V, L.P., Apollo Management VI, L.P., Apollo Management VII, L.P. and Apollo Commodities Management, L.P.*, Advisers Act Release No. 4493 (Aug. 23, 2016) *available* here.

3 *See Apollo Charged with Disclosure and Supervisory Failures*, SEC Press Release 2016-165 (Aug. 23, 2016) *available* here.

ii. adequately disclose certain information about interest payments made on a loan between Apollo's affiliated general partner and five funds; and

iii. supervise a former senior partner who allegedly had improperly charged personal items and services to Apollo-advised funds and their portfolio companies.

Acceleration of Monitoring Fees

The first of Apollo's alleged violations related to monitoring agreements of the sort which private equity fund advisers often enter into with the portfolio companies that are owned by their private equity funds. The agreements into which Apollo entered do not appear to be significantly different from those in which other private equity managers have entered that have drawn the ire of the SEC. Apollo entered into monitoring agreements that typically provided for 10 years of monitoring and service fees in exchange for consulting and advisory services to each portfolio company. The monitoring agreements allowed Apollo to accelerate the remaining years of monitoring fees and to receive a present-value lump sum "termination payment" upon the private sale or initial public offering ("IPO") of a portfolio company. The SEC acknowledged that many of the accelerated fees offset management fees otherwise payable by limited partners of the Apollo-advised funds, but alleged that the net amount of payments reduced the portfolio companies' value prior to their sale or IPO, thereby reducing the amounts available for distribution to the limited partners.

The SEC alleged that, in some instances, Apollo accelerated monitoring fees upon the private sale of a portfolio company even though the Apollo fund owning the portfolio company had completely exited the investment. The SEC alleged that, in other instances, Apollo accelerated monitoring fees beyond the period of time a fund held an investment in a publicly traded portfolio company. The SEC indicated that Apollo disclosed its ability to collect certain consulting, advisory and transaction fees prior to a fund's limited partners committing capital to the fund, but did not disclose its practice of accelerating monitoring fees until after the limited partners committed their capital and the accelerated fees had been paid. The SEC asserted that Apollo could not effectively consent to the practice of accelerating monitoring fees on behalf of the funds because of its conflict of interest as the recipient of the fees.

Allocation of Interest on Affiliate Loan

Apollo's second alleged violation related to a loan agreement into which the general partner of an Apollo-advised fund entered in 2008 with the fund and four other funds investing parallel to the first (collectively, the "Lending Funds"). The Lending Funds loaned the Apollo-affiliated general partner approximately $19 million, an amount equal to carried interest that was then due to the general partner resulting from the recapitalization of two portfolio companies owned by the Lending Funds. According to the SEC, the loan had the effect of deferring taxes that the general partner would have owed on the carried interest until the loan was extinguished.

From June 2008 through August 2013, the Lending Funds' quarterly and annual financial statements disclosed the amount of interest that had accrued on the loan and included the interest as an asset of the Lending Funds; however, the

Lending Funds' financial statements did not disclose that the accrued interest on the loan would be allocated solely to the capital account of the general partner. The SEC alleged that the failure to disclose that the accrued interest would be allocated solely to the capital account of the general partner "rendered the disclosures in the Lending Funds' financial statements concerning the interest materially misleading."[4]

Failure to Supervise Expense Reimbursement Practices

Perhaps the most noteworthy of the violations that the SEC asserted against Apollo was an allegation of a failure to supervise expense reimbursement practices related to personal expenses that the SEC said were improperly charged by a former Apollo senior partner to Apollo-advised funds and their portfolio companies from January 2010 through June 2013. The SEC noted that "[i]n certain instances, the [p]artner submitted fabricated information to Apollo in an effort to conceal his conduct. In other instances, the personal expenses on their face appeared to have a legitimate business purpose."[5] According to the SEC, the former partner's expenses were reviewed on two occasions and resulted in verbal reprimand but no other remedial or disciplinary steps, before a firm-wide review of expenses that led to the partner's separation from the firm and reimbursement of the expenses. Anthony S. Kelly, Co-Chief of the SEC Enforcement Division's Asset Management Unit, noted that "Apollo failed to take appropriate action to protect its clients upon first learning that a partner was improperly expensing personal items and services to the funds, and its failure resulted in repeated misconduct."[6] The SEC's calling into question when and how an investment adviser reprimanded an employee for a violation of internal policies seems unprecedented. The SEC's action in this regard is particularly significant in view of Apollo's having voluntarily reported the partner's expenses issues it discovered to the SEC staff.

Conclusion

The SEC charged Apollo with violating Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 and Rules 206(4)-7 and 206(4)-8 thereunder. Without admitting or denying the findings, Apollo agreed to pay $37.527 million in disgorgement, $2.727 million in interest and a $12.5 million penalty. The SEC granted Apollo Global Management, LLC a waiver from ineligible issuer status under Rule 405 of the Securities Act of 1933.[7]

The SEC's view that the ability to accelerate monitoring fees should be disclosed in advance of limited partners' committing capital to a fund presents an industry-wide issue relating to a common past practice. The reporting of accrued

4 *Apollo Management V, L.P.*, *supra* note *2*; Because the Lending Funds loaned an amount to the general partner that was equal to the amount the general partner was entitled to receive as carried interest, they were in effect lending the general partner "its own money" and Apollo appears to have taken the view that it was reasonable to allocate the interest on the loan to the general partner.

5 *Id.*

6 *Apollo Charged with Disclosure and Supervisory Failures*, *supra* note 3.

7 *Apollo Global Management, LLC – Waiver Request of Ineligible Issuer Status under Rule 405 of the Securities Act*, (Aug. 23, 2016) *available* here.

interest with respect to the fund loan to the general partner is a more technical allegation, while the failure-to-supervise claim suggests further scrutiny of expense reimbursement controls and practices. In light of this enforcement action and the SEC's continued focus on private equity fees and expenses, firms should review their disclosure and business practices with respect to acceleration of monitoring fees, disclosure of potential conflicts and reporting of affiliate arrangements, and internal controls and escalation relating to personal expense matters.

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