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SEC Regulatory Update

By Scott A. Arenare, Barry P. Barbash, Justin L. Browder, James R. Burns, and Elizabeth P. Gray

SEC Enforcement Director Reviews Focus on Private Equity

On May 12, 2016, Andrew Ceresney, director of the Division of Enforcement (Enforcement) of the Securities and Exchange Commission (SEC), gave a speech[1] reviewing Enforcement's focus on the private equity industry over the past several years. The speech followed previous public statements concerning the industry by senior SEC Staff[2] and may have signaled the next round of proceedings brought against managers that are seen as having failed to satisfy their fiduciary obligations under the Investment Advisers Act of 1940 (Advisers Act). Ceresney noted that Enforcement's Asset Management Unit had brought eight actions against private equity managers and he stated that there were "more to come." He also noted that the issues referenced in these cases were often identified by the SEC's Office of Compliance Inspections and Examinations, which referred the examination findings to Enforcement for further action.

Rejecting the notion that private equity investors are sophisticated parties not needing the protections afforded by examinations and enforcement actions, Ceresney observed that retail investors are significantly invested in private equity as underlying beneficiaries of employee benefit plans. He further noted that even experienced plan investors and other institutional limited partners may lack transparency into private equity fees and expenses and operating practices.

Recent SEC Enforcement Actions

Ceresney highlighted a number of recent enforcement actions against private equity managers,[3] grouping them into three interrelated categories: (i) undisclosed fees and expenses; (ii) impermissible shifting and misallocation of expenses; and (iii) failure to adequately disclose conflicts of interests, including those arising from fee and expense issues.

Ceresney cited, with respect to undisclosed fees and expenses, the 2015 proceeding against The Blackstone Group, in which Blackstone allegedly (i) failed to disclose to its funds and fund investors, prior to their commitment of capital, that it might accelerate monitoring fees paid to Blackstone by its portfolio companies upon termination of the monitoring agreements; and (ii) failed to inform fund investors about a fee arrangement with an outside law firm that provided Blackstone, as a firm, with a substantially greater discount on legal services than the discount provided to the funds. Highlighting the importance of full transparency on fees and conflicts of interest, he noted that Blackstone breached its fiduciary duty in securing greater benefits for itself than for its fund clients without properly disclosing and obtaining informed consent for those arrangements.

Three enforcement actions involving undisclosed expense shifting were noted: (i) the 2015 proceeding against KKR, in which the firm was accused of failing to allocate certain broken deal expenses to its separate accounts and proprietary investment vehicles; (ii) a 2014 proceeding in which Lincolnshire Management was alleged to have misallocated expenses among two portfolio companies that were owned by two different private equity funds with different investors; and (iii) a 2015 proceeding involving Cherokee Partners in which the SEC charged private equity fund managers with improperly allocating their own consulting, legal and compliance-related expenses to their funds in contravention of the funds' organizational documents. According to Ceresney, these cases stand for the proposition that when a manager engages in transactions on behalf of itself and multiple funds or other clients, the manager must be mindful of the separate fiduciary duty it owes to each client and must take care not to benefit itself or one client at the expense of another.

Finally, Ceresney discussed two cases in which a fund manager failed to disclose conflicts of interest to its fund advisory committee. In the first case, the SEC accused Fenway Partners and several of its principals with failing to disclose certain conflicts of interest relating to monitoring fees paid by the fund to a Fenway Partners affiliate (without offset against the management fee) and incentive compensation paid to Fenway Partners employees upon a portfolio company exit. In the second case, the SEC charged JH Partners, a manager of three private equity funds, with failing to adequately disclose potential conflicts arising from insider loans and a cross-fund investment and permitting violations of fund concentration limits. These cases, Ceresney observed, underscore the fundamental fiduciary principle that requires a fund manager to make full disclosure of all material facts relating to its advisory services along with all material conflicts of interest between the manager and its funds.

In addressing arguments raised by private equity firms in the course of investigations—that disclosures were often drafted long before the Advisers Act's registration requirements applied to the firms, that investors may have benefited from a perceived conflict and that disclosures were prepared with advice of counsel—Ceresney consistently emphasized the fiduciary obligations of investment advisers and the obligation to disclose conflicts of interest.

Effects on the Industry Going Forward

Ceresney noted that the SEC's recent enforcement actions have caused private equity managers to enhance their disclosures on Form ADV and in PPMs and fund agreements, and to reconsider previously common practices that are now subject to greater scrutiny. Ceresney pointed out that the SEC's enforcement actions have not taken a position on the propriety of specific fees, but he also acknowledged that Blackstone changed its practices regarding acceleration of certain monitoring fees—a remedial action that the SEC took into account in settling with the firm.

Ceresney did not provide a clear indication of types of actions relating to private equity fees the SEC might seek to bring in the future. The SEC would seem in this regard to lack legal precedent for bringing a case asserting that a particular fee charged by a manager and appropriately disclosed could be deemed to constitute a breach by the manager of a fiduciary duty. But with the recognition that even the threat of SEC action can lead to changes in industry behavior, it is possible that Enforcement will pursue such cases and continue to bring about regulation by enforcement proceeding.

Soon after Ceresney spoke about past private equity settlements, the SEC gave an indication of a possible next wave of enforcement actions. In June 2016, the SEC settled an action with Blackstreet Capital[4] involving fees and expenses and conflicts, but also alleging that the private equity manager's receipt of transaction-based compensation for services provided to its portfolio companies constituted broker-dealer activity and that the manager should have been registered as a broker-dealer under the Securities Exchange Act of 1934. The question of whether a private equity firm's activities supporting transactions by its portfolio companies, or even the firm's own fundraising practices, constitute broker-dealer activity has been a long-standing industry-wide discussion, but there had been a view that certain activities were generally permissible without broker-dealer registration or that the issue would be addressed in SEC Staff guidance.

We expect there will be more to come from Enforcement on disclosure and conflicts of interest with respect to private equity fees and expenses, as well as investment activities generally. Private equity firms should continue to review their practices in light of SEC examination priorities, the themes emphasized in remarks such as Ceresney's, the recent focus on broker-dealer registration and evolving best practices in the industry.

Mr. Burns and **Ms. Gray** are partners and **Mr. Browder** is an associate in the Washington, DC office, **Mr. Barbash** is a partner in the New York City and Washington, DC offices, and **Mr. Arenare** is Counsel in the New York City office, of Willkie Farr & Gallagher LLP.

NOTES

1 Andrew Ceresney, Director, Division of Enforcement, "Private Equity Enforcement," May 12, 2016, available at *https://www.sec.gov/news/speech/private-equity-enforcement.html.*

2 *See* Marc Wyatt, Acting Director, Office of Compliance Inspections and Examinations, "Private Equity: A Look Back and a Glimpse Ahead," May 13, 2015, available at *https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html*; Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, "Spreading Sunshine in Private Equity," May 4, 2014, available at *https://www.sec.gov/news/speech/2014--spch05062014ab.html.*

3 For a more detailed analysis of the enforcement actions outlined in Ceresney's speech, please see the firm's previous client memoranda discussing the *KKR* (July 2, 2015), *Blackstone* (Oct. 8, 2015), *Fenway Partners* and *Cherokee Partners* (Nov. 9, 2015) and JH Partners (November 30, 2015) cases.

4 See the firm's client memorandum discussing this case and private equity broker-dealer registration issues (June 2, 2016).