

Compliance Corner
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Lessons for Private Fund Managers in Recent SEC Enforcement Actions

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This past year saw the SEC intensify its longstanding scrutiny of the fees and expenses charged to private funds. In addition to the sweeping rule changes to the private fund landscape proposed in February 2022, the SEC continued to bring enforcement actions involving private funds. Shortly before the end of its 2022 fiscal year, the SEC brought three enforcement actions involving the calculation of private fund fees that offer practical lessons for private fund managers. In this article, we analyze those enforcement actions and suggest pragmatic steps that private fund managers can take to mitigate regulatory risk arising from the calculation of management fees for their funds.

Background

The SEC's interest in fee calculation is an extension of its years-long focus on private fund fees and expenses. As an expression of the relationship between the fund and the manager, the management fee is a natural target for regulatory attention—and the SEC staff has consistently prioritized private fund fee issues in the examination process.¹



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On the enforcement side, one of the persistent themes in this area has been advisers failing to calculate fees properly.ⁱⁱ In a 2018 action, for example, a private fund manager allegedly failed to offset consulting fees as required by fund documents.ⁱⁱⁱ Those documents indicated that the manager would receive transaction fees from the funds' portfolio companies for certain services provided by the manager, including consulting fees. They also required the manager to offset a specified percentage of transaction fees it received against the management fees paid by the funds. The manager, however, failed to offset hundreds of thousands of dollars in consulting fees, resulting in the funds and their limited partners overpaying management fees. Other fee calculation cases have involved, among other things, management fees that were not adjusted properly following write-downs of private equity investments.^{iv}

Recent Fee Calculation Cases

The SEC settled three cases involving issues with private fund fee calculations shortly before the end of its 2022 fiscal year that offer lessons for other advisers to private funds.

In the first case, the SEC settled charges with a venture capital fund manager for allegedly overcharging two of its funds due to errors in its management fee calculations.^v According to the SEC's order, the manager made four errors in calculating the management fee, resulting in the funds being charged fees in excess of what was provided for in their governing documents.

- First, the manager failed to make adjustments to its management fee calculations for write-downs of fund investments. The funds' governing documents provided that dispositions of fund investments, including write-downs, would reduce the asset base used to calculate management fees.
- Second, the manager incorrectly calculated management fees based on aggregate invested capital at the portfolio-company level, which was not permitted by fund documents, instead of at the individual portfolio-company-security level.
- Third, the manager incorrectly included accrued but unpaid interest as part of the basis of the calculation of management fees for certain investments, which was not permitted by fund documents.
- Fourth, the manager failed to initiate the funds' post-commitment management fee period on the correct date.^{vi} As a result, the manager incorrectly based certain fees on investors' committed capital, rather than invested capital net of dispositions. The discussion of the errors called out in the SEC's order reflects the granular nature of the staff's inquiry into fee calculations.

In the second case, affiliated private equity fund managers were alleged to have failed to fully disclose their practice for calculating and charging certain fees.^{vii} In addition to investment advisory services, one of the managers also provided ancillary and underwriting services for the funds. This manager included as a cost component of its ancillary and underwriting fees the anticipated U.S. income tax liability of its founder in respect of such fees, which amounted to \$54.6 million. The SEC's order finds that inclusion of this cost component and the basis for it were not disclosed to the funds or their investors. The order also finds that this fee component was not authorized to be charged without full and fair disclosure to the funds. Lastly, the order finds that the managers failed to implement appropriate policies and procedures in connection with conflicts of interest and disclosure of fees charged to advisory clients.

In the third case, a private equity fund manager allegedly failed to offset fund management fees properly.^{viii} Under the fund's governing documents, fees paid by the funds for third-party placement agent services were to be offset against the fund's management fee. According to the SEC's order, however, the manager did not offset any part of the nearly \$1 million paid to placement agents over several years. In addition, the order finds that the manager failed adequately to disclose to investors and potential investors its failure to repay the amounts owed in the manner required by the fund's governing documents. Curiously, the order does not address the manager's policies and procedures or find that the manager violated Rule 206(4)-7 under the Advisers Act, notwithstanding that the adviser was registered with the Commission for part of the period covered by the order.

Takeaways from Recent Fee Calculation Cases

The SEC likely will continue to scrutinize private fund management fee calculations closely. Advisers to such funds can take some practical steps to meet that scrutiny:

- Ensure that all staff involved in conducting and reviewing the fee calculations have a thorough understanding of how the fees are to be calculated in accordance with the fund's governing documents.
- A fund's governing documents must be followed carefully when calculating fees. The process for calculating fees should be memorialized and compared against fund documents for accuracy and completeness.
- Events that would trigger an alteration in fee calculations should be cataloged and monitored.
- Periodic reviews of fund calculation practices can help uncover issues proactively. All of the orders make note of the remedial steps undertaken by each manager, including whether those steps were taken before or after the SEC's investigation began.

- Fee calculation practices and any associated conflicts of interest must be disclosed clearly to investors.
- Changes to fee calculation practices should be assessed for consistency with fund documents and appropriately disclosed to investors or a fund conflicts committee.

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Disclosure: Aderton directly supervised the investigations that led to certain of the enforcement actions referenced in this article.

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ⁱ See SEC Division of Examinations (“EXAMS”), [2023 Examination Priorities](#) (Feb. 7, 2023); EXAMS, [2022 Examination Priorities](#) (Mar. 30, 2022); EXAMS, [Observations from Examinations of Private Fund Advisers](#) (Jan. 27, 2022); EXAMS, [Division of Examinations Observations: Investment Advisers’ Fee Calculations](#) (Nov. 10, 2021); EXAMS, [Observations from Examinations of Investment Advisers Managing Private Funds](#) (June 23, 2020).

ⁱⁱ *E.g.*, [Advisers Act Rel. No. 5074](#) (Dec. 13, 2018); [Advisers Act Rel. No. 5096](#) (Dec. 26, 2018).

ⁱⁱⁱ [Advisers Act Rel. No. 4951](#) (June 29, 2018).

^{iv} [Advisers Act Rel. No. 5617](#) (Oct. 22, 2020).

^v [Advisers Act Rel. No. 6104](#) (Sept. 2, 2022).

^{vi} This issue has been called out expressly by EXAMS in its examination priorities. See 2023 Examination Priorities, at 10; 2022 Examination Priorities, at 12.

^{vii} [Advisers Act Rel. No. 6120](#) (Sept. 12, 2022).

^{viii} [Advisers Act Rel. No. 6146](#) (Sept. 23, 2022).