CLIENT MEMORANDUM

Private Equity – Allocation of Broken Deal Expenses

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The regulatory focus on private equity fees and expenses continues, with the first case by the Securities and Exchange Commission charging a private equity manager with misallocating broken deal expenses. On June 29, 2015, the SEC charged Kohlberg Kravis Roberts & Co. with misallocating more than $17 million in broken deal expenses to its flagship private equity funds in breach of its fiduciary duty. KKR agreed to pay nearly $30 million to settle the charges, including a $10 million penalty.[1]

The case reflects the continued emphasis by the SEC and its examination staff on private equity fees and expenses, including allocation issues between firms and funds and the shifting of various expenses to a main external fund – viewed in the context of potential conflicts of interest and the increased focus on disclosure of operating practices.[2] It is a strong reminder for private equity firms to maintain detailed expense allocation policies among the funds and accounts they manage and to review and, if necessary, enhance the level of disclosure in the offering and governing documents of their funds with respect to such allocation practices.

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[1] KKR neither admitted nor denied the SEC's findings. *See* SEC Press Release, "SEC Charges KKR With Misallocating Broken Deal Expenses" available at http://www.sec.gov/news/pressrelease/2015-131.html

[2] *See* "Private Equity: A Look Back and a Glimpse Ahead," speech by Marc Wyatt, Acting Director, Office of Compliance, Inspections and Examinations, May 13, 2015 available at http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html

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The action originated from a 2013 examination of KKR conducted by the Office of Compliance Inspections and Examinations. According to the SEC, for the period from 2006 to 2011 (except for a partial allocation to certain co-investors in 2011), KKR allocated broken deal expenses to its flagship private equity funds but did not allocate a portion of these broken deal expenses to co-investment vehicles that invested alongside the flagship funds. Notably, the order indicates that the co-investment vehicles not bearing a portion of broken deal expenses included dedicated vehicles established for investment by KKR employees and consultants (which vehicles co-invested on a deal-by-deal basis).

Typically, the governing documents of a private equity fund include provisions to the effect that broken deal expenses (i.e., research costs, travel costs and professional fees, and other expenses incurred in deal sourcing activities related to specific investments that never materialize) are borne by the fund, as expenses incurred by the manager in sourcing deals for the benefit of the fund and its investors.[3] Managers have also been reimbursed for broken deal expenses by deducting such expenses from "other fees" that the adviser may receive in connection with investments (e.g., monitoring, transaction and break-up fees) that would otherwise be applied to offset the management fee charged to the fund.[4]

In the KKR case, the SEC alleged that the failure to allocate a portion of broken deal expenses to the co-investing entities constituted a violation of Section 206(2) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which prohibits an investment adviser, directly or indirectly, 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 order noted that the marketing materials and the governing documents of the KKR flagship private equity funds did not contain disclosure that the co-investment vehicles were not allocated any share of broken deal expenses. In addition, the order alleged violations of Section 206(4) of the Advisers Act and Rule 206(4)-7, which requires a registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, based on the lack of a written expense policy prior to 2011.

We surmise that the SEC was influenced in this case by the perceived self-dealing of employee investment vehicles that did not bear a portion of broken deal expenses. While the case involved past practices and notes KKR's remedial actions and a new allocation methodology, the action may not fully recognize that the allocation of broken deal fees and expenses in private equity can be nuanced and involve questions of judgment regarding costs associated with deals and potential co-investment. Early stage work with advisors typically begins before a co-investment strategy is in place, and deals often die before potential co-investors are committed or before any co-investment vehicle is established. Firms with multiple products having different investment mandates may not even be in a position, at an early stage, to know where an investment opportunity or related expenses would ultimately be allocated.

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[3] Firms with fixed co-investment arrangements will generally allocate these expenses pro rata based on commitments.

[4] The order indicates that KKR bore 20% of broken deal expenses pursuant to fee sharing arrangements.

Recognizing this subtlety, private equity firms should have compliance policies and procedures in place regarding the allocation of fees and expenses – including broken deal fees and expenses – among various funds, co-investment entities, potential third-party co-investors and managed accounts, with consideration of various factors and review of determinations at various stages as the investment opportunity develops. The allocation of broken deal fees and expenses consistent with such a policy and process, coupled with disclosure of practices to investors, should be protective of such determinations.

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