CLIENT ALERT

SEC Fines Private Equity Adviser for Misallocating Expenses and Failing to Disclose Fee-Sharing Arrangements with Co-Investors

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A recent settlement by the Securities and Exchange Commission (the "SEC") with a New York-based investment adviser (the "Adviser") highlights the continued regulatory focus on expense allocation and co-investment practices among private equity sponsors.[1]

Background

The Adviser managed multiple private equity funds, including its flagship funds (the "Flagship Funds"), which were offered to third-party investors, and other funds that were managed on behalf of the firm's employees (the "Employee Funds"). The Employee Funds invested side-by-side on a proportional basis in the portfolio companies in which the Flagship Funds invested. In addition, co-investors were permitted to provide additional equity capital to invest in deals once the Adviser had determined the appropriate size of a prospective investment by the Flagship and Employee Funds. The Flagship Funds were governed by limited partnership agreements, private placement memoranda, and investment advisory agreements (collectively, the "Organizational Documents"). Each Flagship Fund also established an Advisory Committee to approve or disapprove conflicts of interest between a Flagship Fund and its general partner, an affiliate of the Adviser. In addition, the Adviser often entered into advisory agreements with portfolio companies to provide advisory services in

[1] *See In re* Lightyear Capital LLC, Investment Advisers Act Release No. 5096 (Dec. 26, 2018).

exchange for fees. As is common among recent-vintage funds, the Organizational Documents required the Adviser to offset the fees received from the portfolio companies against the management fees paid by the Flagship Funds.

Expense Allocation

The SEC alleged that, from 2000 through 2016, the Adviser misallocated a total of $388,000 in expenses to its Flagship Funds that should have been allocated to the Employee Funds and other co-investors. The settlement order alleges that the Adviser allocated broken deal, legal, consulting, insurance and other expenses solely to its Flagship Funds without disclosing that the Employee Funds and co-investors would not bear their proportional share of the expenses. The Organizational Documents for the Flagship Funds disclosed that the Funds would be allocated expenses incurred in connection with potential or actual investments by the Flagship Funds and permitted the general partner of the Flagship Funds to negotiate different investment terms for co-investors. The Organizational Documents, however, did not disclose that neither the Employee Funds nor the co-investors would bear their proportional share of those expenses despite the fact that they participated in, and benefitted from, the investments. According to the SEC, the Adviser should have disclosed that the Flagship Funds would pay all of the expenses in connection with the transactions. In the absence of that disclosure, the Adviser should have allocated to the Employee Funds and co-investors their proportional share of the expenses, borne the costs itself, or obtained approval from the Flagship Funds' Advisory Committees of the conflicts of interest. Because the Adviser did not take any of these steps, the Adviser's misallocation of expenses benefitted the Employee Funds and the co-investors at the expense of the Flagship Funds.

Fee-Sharing Arrangements

The SEC separately alleged that, from 2010 through 2015, the Adviser failed properly to offset approximately $1 million in management fees paid by the Flagship Funds. The Adviser had entered into fee-sharing agreements with certain co-investors whereby the Adviser agreed to share with the co-investors a portion of the advisory fees received from the Flagship Funds' portfolio companies. Although the Organizational Documents allowed the general partner of the Flagship Funds to negotiate different investment terms for co-investors, the Adviser did not disclose the fee-sharing agreements. According to the SEC, these arrangements reduced the amount of fees that were subject to the Flagship Funds' offset provisions and thereby increased the management fees paid by the Flagship Funds. The SEC also alleged that the Flagship Fund investors had no way of knowing that the management fee offsets received were less than the Funds would have received without the fee-sharing arrangements because the payments generally were made directly to the co-investors.

Compliance Policies and Procedures

In connection with the Adviser's substantive failures, the SEC alleged that the Adviser did not adopt written policies and procedures to address how it allocated fees and expenses until May 2017, or to govern the application of the management fee offsets in connection with its fee-sharing arrangements with co-investors. The SEC specifically noted the failure of the Adviser's policies and procedures to handle broken deal expenses, which, according to the Organizational Documents, the Adviser should have attempted to recoup from prospective portfolio companies.

Settlement

As a result, the SEC asserted that the Adviser violated Section 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act"), which prohibits transactions, practices, or courses of business which operate as a fraud or deceit upon a client. The SEC also alleged a violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibits untrue statements or omissions of material facts to investors in a pooled investment vehicle and acts, practices or courses of business that are fraudulent, deceptive, or manipulative with respect to those investors. Finally, the SEC alleged a violation of Rule 206(4)-7 under the Advisers Act, which requires an adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. In addition to ordering the Adviser to cease and desist from further violations of the Advisers Act, the SEC ordered the Adviser to pay a civil monetary penalty of $400,000. The SEC noted that the Adviser had already made full reimbursement to the Flagship Funds prior to the entry of the settlement.

Conclusion

The settlement is an important reminder to private equity advisers of the SEC's continued focus on expense allocation practices. It also highlights the need for advisers to consider carefully the impact of co-investment programs. In light of the SEC's ongoing scrutiny of these issues, advisers should continually evaluate the disclosures made to fund investors to ensure that certain funds and/or co-investors are not benefitting, at the expense of other firm clients, from undisclosed or underdisclosed practices.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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