CLIENT ALERT

# SEC Enforcement Against Private Equity Firms in 2018: Year in Review

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In 2018, the Securities and Exchange Commission (the "SEC") continued to pursue a series of enforcement actions against private equity fund sponsors. The issues raised by the cases reflect the SEC's ongoing scrutiny of expense allocation practices, application of management fee offset provisions, acceleration of consulting and advisory fees, unauthorized principal, agency and affiliate transactions, and compliance with regulatory and investor reporting requirements. Many of these issues were first brought to the fore in two notable SEC staff speeches in 2014 and 2015,[1] and the 2018 cases demonstrate that they continue to be of central importance.

Private equity sponsors should continue to remain focused on enhancing their compliance programs in these areas as they move forward in 2019.

[1] *See, e.g.*, Andrew J. Bowden, Director, Office of Compliance Inspections & Examinations ("OCIE"), SEC, "Spreading Sunshine in Private Equity," Address Before the Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014); Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, SEC, "Conflicts, Conflicts Everywhere," Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015).

Expense Allocation Practices

As in prior years, expense allocation practices remained an area of significant interest for the SEC.[2] In one notable case, the SEC sanctioned an adviser that had allocated the salary costs of its own employees who provided tax services to the funds that the adviser managed.[3] Despite the adviser's intention to reduce the funds' tax preparation costs, the SEC alleged that the adviser should have borne the expenses because the funds' organizational documents provided that the adviser would bear the cost of tax returns as well as compensation owed to the adviser's employees, and in any event, the adviser failed adequately to disclose to the funds' investors or the funds' limited partner advisory boards how the adviser allocated the costs of in-house tax personnel.

In another case involving compensation-related expenses, an adviser organized a distinct group of employees to provide certain business-related services, such as client development, talent management, and operational advisory services, to the portfolio companies owned by the adviser's funds. Although the funds agreed to pay the expenses associated with those services (subject to a cap) in addition to paying the adviser its management fee,[4] some of the employees spent time on other tasks that assisted the adviser's investment team—including fundraising efforts and identifying and meeting with potential portfolio companies. The SEC alleged that the expenses attributable to the services the employees provided to the investment team should have been borne by the adviser, yet the adviser failed to make a corresponding adjustment to the expense allocation among the funds and the adviser. While the SEC acknowledged that some of the tasks might have incrementally benefited the portfolio companies and that the allocation had generally remained below the applicable expense cap, the SEC characterized the allocation as inconsistent with the disclosures in the funds' organizational documents, which assigned to the adviser the compensation-related expenses of its investment professionals.

In a third case, the SEC brought charges against an adviser for improperly allocating expenses among its flagship funds, its employee funds, and certain co-investors that participated in individual investments.[5] Over the course of 17 years, the adviser allocated approximately $388,000 in broken deal, legal, consulting, insurance and other expenses solely to its flagship funds and not to the employee funds and co-investors. Although the flagship funds' organizational documents disclosed that they would bear such expenses, the adviser failed to disclose that neither the co-investors nor the employee funds would bear their proportional share of expenses with respect to transactions in which the flagship funds

[2] *See, e.g.*, *In re* First Reserve Management, L.P., Investment Advisers Act Release No. 4529 (Sept. 14, 2016) (sanctioning an adviser for misallocating insurance and subsidiary expenses to its private equity funds and negotiating a discount for legal services for itself, but not the funds, without appropriate disclosure or effective consent); *In re* Kohlberg Kravis Roberts & Co. L.P., Investment Advisers Act Release No. 4131 (June 29, 2015) (charging an adviser with allocating all broken deal expenses to its flagship funds and none to its co-investors); *see also* OCIE, SEC, EXAMINATION PRIORITIES FOR 2015 4 (Jan. 13, 2015) (noting that OCIE will continue to examine private fund advisers "in connection with fees and expenses").

[3] *In re* Yucaipa Master Manager, LLC, Investment Advisers Act Release No. 5074 (Dec. 13, 2018).

[4] *In re* NB Alternatives Advisers LLC, Investment Advisers Act Release No. 5079 (Dec. 17, 2018).

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

invested alongside the employee funds and co-investors. Thus, the SEC alleged that the adviser's expense allocation improperly benefitted the co-investors and employee funds at the expense of the flagship funds.

Application of Management Fee Offset Provisions

The SEC also scrutinized the application of management fee offset provisions in two notable cases.[6] In the first case, an adviser had entered into service agreements with portfolio companies owned by the adviser's funds, and the fees generated by those agreements were supposed to offset the management fees charged to the funds.[7] In addition, the adviser also had entered into fee-sharing agreements with certain co-investors under which the adviser agreed to pay the co-investors a portion of the fees received from the portfolio companies under the service agreements. The SEC asserted that over a six-year period the funds lost out on approximately $1 million in management fee offsets as a result of the adviser's fee-sharing agreements. While the funds' organizational documents permitted the general partner of the funds to negotiate different investment terms for co-investors, the adviser did not disclose either the fee-sharing agreements or the payments. The SEC noted that the funds' investors had no way of knowing that the funds did not receive the management fee offset that they would have received absent the fee-sharing agreements because the payments were generally paid by the portfolio companies directly to the co-investors.

In another case, an adviser engaged a consulting firm to provide services to a portfolio company in which one of the adviser's funds had invested.[8] Under the terms of the fund's limited partnership agreement, the adviser had agreed to reduce the fund's management fees by 70 percent of the portion of all consulting fees received by the adviser's affiliates that were not used to reimburse the adviser's expenses. While the consulting firm was providing services to the portfolio company, the adviser's principal made a personal investment in the consulting firm, resulting in a right to receive 25 percent of its profits. The SEC alleged that the adviser failed to offset the fees paid by the portfolio company to the consulting firm after the principal's investment in the consulting firm, and did not disclose its failure to offset the fees to the fund's advisory board or investors.

[6] *See, e.g.*, *In re* Fenway Partners, LLC et al., Investment Advisers Act Release No. 4253 (Nov. 3, 2015) (sanctioning an adviser for, among other things, failing to disclose conflicts of interest arising from its failure to offset monitoring fees received by an affiliated consulting firm from a fund's portfolio companies against the fund's advisory fee).

[7] *In re* Lightyear Capital LLC, *supra* note 5.

[8] *In re* Yucaipa Master Manager, LLC, *supra* note 3.

Acceleration of Consulting and Advisory Fees

The SEC kept up its scrutiny of disclosures related to accelerated fee arrangements.[9] In one case, an adviser disgorged $4.8 million plus prejudgment interest after the adviser inadequately disclosed its potential receipt of consulting and advisory fees from portfolio companies owned by the adviser's funds.[10] The adviser typically entered into consulting and advisory agreements with portfolio companies that provided for automatic termination of the agreements upon the sale or IPO of the portfolio company. When the agreements automatically terminated, the adviser received an accelerated, lump-sum payment of the fees that would have been payable for providing services for the remaining term of the agreement. The funds' governing documents disclosed that the adviser may enter into consulting agreements with portfolio companies and receive fees, which the adviser would share with the funds' investors in the form of management fee credits. Additionally, with respect to one fund, the adviser entered into certain side-letter agreements that provided, "for the avoidance of doubt," that the adviser may receive fees upon the sale or IPO of portfolio companies, which the adviser also credited against management fees. The adviser provided notice of the side-letter provision to more than three quarters, but not all, of the fund's limited partners. The adviser also disclosed, in semi-annual financial reports provided to all limited partners, the amount of periodic and accelerated fees and the shared and retained portions. In addition, the portfolio companies disclosed the accelerated fees in SEC filings. Despite these disclosures, the SEC alleged that the adviser did not adequately disclose, prior to the limited partners' commitment of capital, that the adviser may receive accelerated fees upon the early termination of portfolio company agreements.

Unauthorized Principal, Agency and Affiliate Transactions

The SEC also continued to scrutinize unauthorized principal, agency and other affiliate transactions.[11] In one case,[12] an adviser, through a wholly owned subsidiary, purchased defaulted consumer receivables from one of the adviser's funds, in which the adviser was the sole remaining investor. The adviser then caused the subsidiary to sell the receivables to another advisory client, which the client financed through a loan received from another of the adviser's funds in exchange for a security interest in the receivables. The SEC alleged that, in violation of Section 206(3) of the Investment Advisers

[9] *See, e.g.*, *In re* Apollo Management V, L.P. et al., Investment Advisers Act Release No. 4493 (Aug. 23, 2016) (sanctioning an adviser that accelerated portfolio company monitoring fees and had failed to disclose to its funds, and to the funds' investors prior to their commitment of capital, that the adviser may accelerate future monitoring fees upon termination of the monitoring agreements); *In re* Blackstone Management Partners L.L.C. et al., Investment Advisers Act Release No. 4219 (Oct. 15, 2015) (charging an adviser with, among other things, failing to adequately disclose to its funds, and to fund investors prior to their commitment of capital, that the adviser had the authority to accelerate future monitoring fees upon the sale or IPO of a portfolio company); *see also* OCIE, SEC, EXAMINATION PRIORITIES FOR 2013 4 (Feb. 21, 2013) (announcing that OCIE will seek out "undisclosed compensation and arrangements and the conflicts of interest that they present").

[10] *In re* THL Managers V, LLC & THL Managers VI, LLC, Investment Advisers Act Release No. 4952 (June 29, 2018).

[11] *See* OCIE, SEC, EXAMINATION PRIORITIES FOR 2017 5 (Jan. 12, 2017) (noting that OCIE will continue to scrutinize "conflicts of interest and disclosure of conflicts").

[12] *In re* Ophrys, LLC, Investment Advisers Act Release No. 5041 (Sept. 21, 2018).

Act of 1940 (the "Advisers Act"), the adviser had failed to provide written disclosure to, or obtain consent from, both the purchasing client and the lending client with respect to the adviser's role as principal in the transaction.

In the same case, the SEC alleged that the adviser engaged in two unauthorized agency transactions involving multiple funds managed by the adviser. In the first agency transaction, the adviser caused one of its funds ("Fund 1") to sell certain defaulted consumer debt receivables to another fund ("Fund 2"). Fund 1 had financed its original acquisition of the receivables through a loan from a third-party lender. Under the terms of the loan agreement, the lender was granted a security interest in the receivables, and the adviser was entitled to receive a percentage of collections on the receivables or a percentage of the net proceeds in the event the receivables were subsequently sold. The SEC alleged that the adviser acted as a broker within the meaning of Section 206(3) of the Advisers Act with respect to the sale of the receivables from Fund 1 to Fund 2, because the sale resulted in the adviser receiving a portion of the proceeds fees under the loan agreement. As a result, the adviser should have provided disclosure to and received consent from the funds. In the second agency transaction, the adviser caused a third fund ("Fund 3") to invest in securities issued by Fund 1. As a result of Fund 3's investment in Fund 1, the third-party lender was paid in full and released its security interests in the remaining receivables held by Fund 1, and the adviser earned additional fees under the loan agreement. The SEC alleged that Fund 3's investment was an agency transaction because the adviser acted as broker within the meaning of Section 206(3) of the Advisers Act on behalf of Fund 1, its advisory client, for the sale of Fund 1 interests to Fund 3, another advisory client, and therefore the adviser should have provided prior written disclosure and obtained consent to the transaction.

Another case involved a service agreement between an adviser and a group purchasing organization (a "GPO"), which the adviser's funds' portfolio companies used to obtain volume discounts from vendors.[13] Under the GPO service agreement, the GPO paid the adviser a share of the fees that the GPO received from vendors as a result of purchases made by the portfolio companies. The SEC alleged that the adviser failed to disclose the conflicts of interest arising out of the service agreement, and was unable to consent on behalf of the funds to those conflicts because, among other things, the organizational documents, which were drafted years before the agreement was in place, had not disclosed that the adviser would receive the fees and the adviser had an incentive to recommend the GPO's services to the portfolio companies.

[13] *In re* WCAS Management Corp., Investment Advisers Act Release No. 4896 (Apr. 24, 2018); *see also In re* Yucaipa Master Manager, LLC, *supra* note 3 (personal investment by adviser's principal in consulting firm providing services to a fund).

Reporting Obligations

The SEC also targeted advisers for failures to comply with routine reporting obligations. In particular, the SEC charged 13 advisers, including several private equity sponsors, with repeatedly failing to file annual reports on Form PF[14] and charged another adviser who, in seeking to comply with the audit exception under the Advisers Act custody rule, repeatedly failed to meet the 120-day time frame for distributing audited financial statements to the investors in the adviser's funds.[15]

Conclusion

The SEC's enforcement activity in 2018 demonstrated that it is still actively punishing private equity advisers with respect to expense allocation practices, application of management fee offset provisions, acceleration of consulting and advisory fees, unauthorized principal, agency and affiliate transactions, and compliance with regulatory and investor reporting requirements. Regardless of whether these are cases from a more active enforcement environment or a reflection of a continued focus, private equity sponsors should continue to remain vigilant and enhance their compliance programs in these areas.

[14] Press Release, SEC Charges 13 Private Fund Advisers for Repeated Filing Failures, No. 2018-100 (June 1, 2018).

[15] *In re* New Silk Route Advisers, L.P., Investment Advisers Act Release No. 4970 (July 17, 2018).

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