CLIENT MEMORANDUM

SEC Enforcement Action Related to Private Equity Fees and Expenses

October 8, 2015

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An enforcement action brought by the Securities and Exchange Commission (the "SEC") against three private equity fund advisers within The Blackstone Group represents a continuing regulatory focus on private equity fees and expenses. On October 7, 2015, the SEC charged Blackstone with failing to adequately disclose to its funds, and to fund investors prior to their commitment of capital, that (1) Blackstone had the authority to accelerate future monitoring fees and exercised that authority upon termination of monitoring agreements and (2) Blackstone had negotiated with its primary outside law firm a discount for external legal fees for the firm that was substantially greater than the discount received by the Blackstone funds. In settling the SEC's action, Blackstone agreed to pay nearly $39 million, including a $10 million penalty.[1]

The settlement centered on Blackstone's practice of entering into monitoring agreements with portfolio companies of the funds under which Blackstone charged monitoring fees (*i.e.*, fees in exchange for rendering certain consulting and advisory services to those portfolio companies).[2] The SEC acknowledged that the funds' documents disclosed

[1] Blackstone neither admitted nor denied the SEC's findings. *See* SEC Press Release, "Blackstone Charged with Disclosure Failures," *available* here.

[2] With respect to the Blackstone funds involved, 50 percent of the monitoring fees were offset against management fees that the investors would otherwise pay to Blackstone.

Blackstone's potential receipt of monitoring fees, but the SEC asserted that Blackstone failed to disclose that the monitoring agreements provided for the acceleration of monitoring fees to be triggered by certain events (*e.g.*, upon either the private sale or IPO of a portfolio company), and that from 2010 to 2015, Blackstone had terminated certain monitoring agreements and accelerated the payment of future monitoring fees. The SEC noted particularly that, in some instances, Blackstone had accelerated the monitoring fees, notwithstanding that a fund had completely exited the portfolio company and Blackstone would no longer be providing any monitoring services. The SEC also highlighted that although Blackstone disclosed the ability to collect monitoring fees to the funds and to their investors prior to their commitment of capital, Blackstone did not disclose to the funds, their investors or the funds' limited partnership advisory committees its practice of accelerating monitoring fees until Blackstone had taken the accelerated fees. Perhaps most noteworthy, the SEC said that the receipt of the accelerated monitoring fees presented Blackstone with a conflict of interest such that Blackstone could not effectively consent to the practice on behalf of the funds.

A second matter underlying the settlement order was an alleged undisclosed discount of legal fees that Blackstone had negotiated with its primary outside counsel. Under the agreement, according to the SEC, Blackstone received a discount for external legal fees that was substantially greater than the discount received by the funds. Blackstone maintained that the discount rate reflected a "different mix of work" performed by the law firm for the funds and for Blackstone. The SEC appears not to have accepted that assertion, concluding that Blackstone failed to adequately disclose the disparate legal fee discounts to the funds and their investors. The SEC also said that Blackstone faced a conflict of interest as the beneficiary of the discounts and could not effectively consent to the practice on behalf of the funds.

The settlement principally involves inadequate disclosure of practices by Blackstone that have since been curtailed, eliminated and/or disclosed to investors. The SEC's order acknowledges remedial efforts by Blackstone, including voluntarily ending the disparate legal fee arrangement and modifying practices relating to the acceleration of monitoring fees (both practices were not uncommon in the industry in the past).

The SEC concluded that Blackstone, in failing to adequately disclose the acceleration of monitoring fees and the disparate legal fee discounts, violated Section 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act"), which prohibits an investment adviser from engaging directly or indirectly "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The SEC also concluded that Blackstone violated Section 206(4) of the Advisers Act and Rule 206(4)-8 under the Advisers Act, which prohibits an investment adviser to a pooled vehicle from making "any untrue statement of a material fact or omit[ting] to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or "engag[ing] in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle." Finally, the SEC found that Blackstone had violated Section 206(4) of the Advisers Act and Rule 206(4)-7 under the Advisers Act, which requires a registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

Upon the announcement of the settlement, Andrew Ceresney, the Director of the SEC's Division of Enforcement, said ominously that "[f]ull transparency of fees and conflicts of interest is critical in the private equity industry and we will continue taking action against advisers that do not adequately disclose their fees and expenses, as Blackstone did here[.]" Julie Riewe, the Co-Chief of the Division of Enforcement's Asset Management Unit, noted that in failing to make appropriate disclosure of the accelerated monitoring fees and different rates for legal services, Blackstone violated its fiduciary duty.

We expect that the Blackstone settlement will not mark the end of the SEC's scrutinizing of fees and expenses charged by private equity and other private fund managers that involve potential conflicts of interest. The SEC noted that the Division of Enforcement's Asset Management Unit is continuing its review of private equity fee and expense issues and encourages private equity managers to self report issues to the SEC staff. The settlement is yet another reminder for private equity managers to review and, if necessary, enhance the level of disclosure in the offering and governing documents of their funds, particularly with respect to any payments that may involve conflicts. Many private equity funds have established advisory committees of unaffiliated investors, and private equity managers may also wish to consider involving a fund's advisory committee in the process of addressing any potential conflicts of interest relating to fee arrangements.

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