

## CLIENT MEMORANDUM

# SEC Enforcement Director Reviews Focus on Private Equity

May 16, 2016

## AUTHORS

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On May 12, 2016, Andrew Ceresney, director of the Division of Enforcement (“Enforcement”) of the Securities and Exchange Commission (“SEC”), gave a speech<sup>1</sup> reviewing Enforcement’s evolving focus on the private equity industry over the past several years. The speech follows previous public statements concerning the industry by senior SEC staff<sup>2</sup> and may signal the next round of proceedings brought against managers that are seen as having failed to satisfy their fiduciary obligations under the Investment Advisers Act of 1940 (“Advisers Act”). Ceresney noted that Enforcement’s Asset Management Unit has brought eight actions against private equity managers, and he stated that there were “more to come.” He also noted that the issues referenced in these cases were often identified by the SEC’s Office of Compliance Inspections and Examinations, which referred the examination findings to Enforcement for further action.

Rejecting the notion that private equity investors are sophisticated parties not needing the protections afforded by examinations and enforcement actions, Ceresney observed that retail investors are significantly invested in private equity

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<sup>1</sup> Andrew Ceresney, Director, Division of Enforcement, “Private Equity Enforcement,” May 12, 2016, available [here](#).

<sup>2</sup> See Marc Wyatt, Acting Director of Office of Compliance Inspections and Examinations, “Private Equity: A Look Back and a Glimpse Ahead,” May 13, 2015, available [here](#); Andrew J. Bowden, Director of Office of Compliance Inspections and Examinations, “Spreading Sunshine in Private Equity,” May 4, 2014, available [here](#).

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## SEC Enforcement Director Reviews Focus on Private Equity

Continued

as underlying beneficiaries of pension plans. He further noted that even experienced pension plan investors and other institutional limited partners may lack transparency into private equity fees and expenses and operating practices.

### Recent SEC Enforcement Actions

Ceresney highlighted a number of recent enforcement actions against private equity managers,<sup>3</sup> grouping them into three interrelated categories: (i) undisclosed fees and expenses; (ii) impermissible shifting and misallocation of expenses; and (iii) failure to adequately disclose conflicts of interests, including those arising from fee and expense issues.

Ceresney cited, with respect to undisclosed fees and expenses, the 2015 proceeding against The Blackstone Group, in which Blackstone allegedly (i) failed to disclose to its funds and fund investors, prior to their commitment of capital, that it might accelerate monitoring fees paid to Blackstone by its portfolio companies upon termination of the monitoring agreements; and (ii) failed to inform fund investors about a fee arrangement with an outside law firm that provided Blackstone, as a firm, with a substantially greater discount on legal services than the discount provided to the funds. Highlighting the importance of full transparency on fees and conflicts of interest, he noted that Blackstone breached its fiduciary duty in securing greater benefits for itself than for its fund clients without properly disclosing and obtaining informed consent for those arrangements.

Three enforcement actions involving undisclosed expense shifting were noted: (i) the 2015 proceeding against KKR, in which the firm was accused of failing to allocate certain broken deal expenses to its separate accounts and proprietary investment vehicles; (ii) a 2014 proceeding in which Lincolnshire Management was charged with misallocating expenses among two portfolio companies that were owned by two different private equity funds with different investors; and (iii) a 2015 proceeding involving Cherokee Partners in which the SEC charged private equity fund managers with improperly allocating their own consulting, legal and compliance-related expenses to their funds in contravention of the funds' organizational documents. According to Ceresney, these cases stand for the proposition that when a manager engages in transactions on behalf of itself and multiple funds or other clients, the manager must be mindful of the separate fiduciary duty it owes to each client and must take care not to benefit itself or one client at the expense of another.

Finally, Ceresney discussed two cases in which a fund manager failed to disclose conflicts of interest to its fund advisory committee. In the first case, the SEC accused Fenway Partners and several of its principals with failing to disclose certain conflicts of interest relating to monitoring fees paid by the fund to a Fenway Partners affiliate (without offset against the management fee) and incentive compensation paid to Fenway Partners employees upon a portfolio company exit. In the second case, the SEC charged JH Partners, a manager of three private equity funds, with failing to adequately disclose potential conflicts arising from insider loans and a cross-fund investment and permitting violations of fund concentration limits. These cases, Ceresney observed, underscore the fundamental fiduciary principle that requires a fund manager to

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<sup>3</sup> For a more detailed analysis of the enforcement actions outlined in Ceresney's speech, please see our previous client memoranda discussing the [KKR](#), [Blackstone](#), [Fenway Partners](#), [Cherokee Partners](#) and [JH Partners](#) cases.

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## SEC Enforcement Director Reviews Focus on Private Equity

Continued

make full disclosure of all material facts relating to its advisory services along with all material conflicts of interest between the manager and its funds.

In addressing arguments raised by private equity firms in the course of investigations – that disclosures were often drafted long before the Advisers Act’s registration requirements applied to the firms, that investors may have benefited from a perceived conflict and that disclosures were prepared with advice of counsel – Ceresney consistently emphasized the fiduciary obligations of investment advisers and the obligation to disclose conflicts of interest.

### Effects on the Industry Going Forward

Ceresney noted that the SEC’s recent enforcement actions have caused private equity managers to enhance their disclosures on Form ADV and in PPMs and fund agreements, and to reconsider previously common practices that are now subject to greater scrutiny. Ceresney pointed out that the SEC’s enforcement actions have not taken a position on the propriety of specific fees, but he also acknowledged that Blackstone changed its practices regarding acceleration of certain monitoring fees – a remedial action that the SEC took into account in settling with the firm.

Ceresney stopped short of saying whether a case might be brought asserting that a particular type of fee, by itself and assuming adequate disclosure, would constitute a breach of fiduciary duty. It is not clear what the statutory basis for such a case would be, but with the recognition that even the threat of SEC action can lead to changes in industry behavior, it is possible that Enforcement could pursue such a case and establish another instance of regulation by enforcement. In the meantime, we expect there will be more to come from Enforcement on disclosure and conflicts of interest with respect to private equity fees and expenses, as well as investment activities generally. Private equity firms should continue to review their practices in light of SEC examination priorities, the themes emphasized in remarks such as Ceresney’s, and evolving best practices in the industry.

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