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Top Five Private Equity Practices Grabbing SEC Attention

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Private equity firms have definitely been feeling the heat since the SEC's director of the enforcement, Andrew Ceresney, announced the SEC's intensifying enforcement focus on them in a May 2016 keynote speech. Indeed, at least one large settlement with private equity advisors, totaling over $50 million, has been announced since Mr. Ceresney's speech, adding to the SEC's pile of private equity settlements that begun rapidly growing in 2015. Private equity firms wondering how to avoid being caught under the SEC's microscope would be wise to examine the recent enforcement actions that have been announced. These actions demonstrate a number of deal/agreement characteristics that have been currently grabbing the SEC's attention, such as:

Allocation of Transaction Fees

In August 2016, the SEC settled with a PE advisor for a $2.3 million penalty following voluntary reimbursement, with interest, of nearly $12 million in management fee credits. In providing various services to portfolio companies, the advisor earned certain transaction fees. Under the terms of the limited partnership agreements, the advisor was to offset the management fee it charged the funds by 50% of the fees earned. The LPAs did not specify how the advisor was to allocate such fees in situations involving multiple funds and co-investors investing in the same portfolio companies. The advisor retained 60% of such fee from a co-investor for negotiating, advising, and structuring a transaction. The SEC faulted the advisor for not disclosing its practice and interpretation of LPA language the SEC conceded was "ambiguous."

Accelerated Monitoring Fees

In a second settlement announced August 2016, four private equity fund advisors paid $52.7 million in an action which alleged that the advisors failed to properly disclose to investors the practice of taking accelerated fees. Specifically, the private equity firm entered into "monitoring agreements" with portfolio companies that allowed the firm to charge monitoring fees to the portfolio company in exchange for rendering certain consulting and advisory services. The monitoring agreements allowed the firm to terminate the monitoring agreement and accelerate the remaining years of monitoring fees, which it received as "termination payments." While the firm disclosed its ability to collect these acceleration fees, it did not disclose its practice of taking acceleration fees until after it had already taken the fees. Notably, another settlement regarding accelerated monitoring fees was also announced in October 2015 and a probe into another firm regarding accelerated fees was reported this month.

Broken Deal Expenses

The SEC has also scrutinized misallocation of broken deal expenses (diligence expenses related to unsuccessful buyout opportunities) to an advisor's private equity funds. Under some limited partnership agreements, fund managers are permitted to be reimbursed by funds for broken deal expenses that are incurred "by or on behalf of" the fund. However, when firms fail to allocate broken deal expenses to the firm's co-investors or fail to disclose not allocating broken deal expenses to co-investors, even if the co-investors participated in and benefitted from the expenses, the SEC takes issue.

Rerouting Fees to Avoid Offsets

In another case involving monitoring fees, a private equity firm and certain executives paid $10.2 million to settle an action that claimed the firm rerouted fees to an affiliate and avoided providing the benefits of the fees to the client through an offset. The firm originally had monitoring agreements with its portfolio companies to obtain monitoring fees for providing management services, and those fees were to be offset against the client's advisory fees. Terminating those original agreements, the firm caused the portfolio companies to enter into monitoring agreements with the firm's affiliates and then failed to provide any further offsets.

Allocation of Firm's Registration Expenses to Investor

An action alleging the misallocation of the private equity firm's registration expenses to client funds was settled in November 2015 for $100,000. According to the SEC's allegations, the firm incurred consulting, legal and compliance-related expenses in the course of preparing for registration as an investment advisor, complying with obligations as an investment advisor and responding to investigation requests. The firm caused the client funds to pay for almost $500,000 of those expenses. Although the limited partnership agreements disclosed that the client funds could be charged for expenses in the "good faith judgment" of the general partner, there was no disclosure that the client funds would be charged for the firm's legal and compliance expenses.

Whether in limited partnership agreements, subscription agreements, Form ADVs or elsewhere, the SEC scrutinizes any difference between what managers said they would do and what they actually did—particularly when the manager enjoys a financial benefit as a result. With the SEC pushing the legal envelope through settled actions, it pays investment advisors to stay well within the lines.

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