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PERSPECTIVE

# SEC taking hard look at private equity

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In recent months, through public statements by commissioners and other senior officials and enforcement actions, the Securities and Exchange Commission has demonstrated its intensifying enforcement focus on private equity firms. Most recently, Andrew Ceresney, the director of the SEC's Division of Enforcement, addressed a gathering of securities and in-house professionals to explain the SEC's newest enforcement priority. His statements, combined with recent SEC enforcement actions, leave no doubt about the agency's commitment to patrolling the private equity beat.

In his speech, Ceresney offered three reasons to explain why the SEC was committing resources to policing private equity firms.

• First, private equity investments have exploded in the past decade. From 2000 to 2015, private equity investments have grown from just over $700 billion to over $4.2 trillion, a sixfold increase.

• Second, private equity's unique characteristics cause the SEC to believe that investors in private equity require additional protection. Private equity investors commit their capital to investments that are unlikely to pay returns for 10 years or more, which the SEC believes makes it critical for advisers to disclose all material information, including conflicts of interest, to investors at the time capital is committed.

• Third, retail investors are significantly invested in private equity. Public pension plans, institutional investors, and university endowments, among others, invest in private equity funds, exposing their investors and beneficiaries — for example, teachers, public safety officers, 401(k) and IRA investors, and students — to the consequences of private equity fraud.

Recent SEC enforcement actions — with the omnipresent specter of more on the way — highlight three areas about which private equity advisers should be particularly vigilant: undisclosed fees and expenses, expense shifting and misallocation, and failure to disclose conflicts of interest.

### Undisclosed Fees and Expenses

The SEC considers the issue of undisclosed fees and expenses to be a breach of fiduciary duty, as it concluded in its enforcement action against The Blackstone Group filed in October 2015. In that action, the SEC charged Blackstone with two distinct disclosure failures, for which Blackstone paid $39 million, including a $10 million civil penalty, to settle the charges.

According to the SEC's order, Blackstone failed to disclose its practice of accelerating future monitoring fees beyond the period during which Blackstone held an investment in a company. Private equity fund advisers like Blackstone typically enter into agreements with their portfolio companies to provide monitoring services in exchange for a fee. Many of these agreements provide that, upon the company's IPO or sale, the fees that remain due under the agreement accelerate, allowing Blackstone to receive a present value lump sum payment.

The accelerated payments to Blackstone, however, come from the portfolio companies' assets, purportedly reducing the value of the portfolio companies prior to sale and harming the funds and their investors. Because private equity investors do not have transparency into the agreements between advisers and their portfolio companies, they may not be aware of such accelerated payments; in fact, Blackstone did not disclose these payments to investors until after it received the fees. As a result, according to the SEC, the practice of collecting accelerated payments should be disclosed when investors commit their capital.

Second, the SEC charged that Blackstone failed to disclose a fee arrangement that provided it with a substantially greater discount on legal services provided by an outside law firm than the discount that the law firm provided to the funds. Blackstone secured this favorable arrangement even though the funds generated far more legal fees than Blackstone. In doing so, according to the SEC, Blackstone breached its fiduciary duty by obtaining greater benefits than the funds it advised without proper disclosure of and consent for the arrangement.

### Expense Shifting and Misallocation

A second group of recent SEC enforcement actions, including actions against Lincolnshire Management Inc., Kohlberg Kravis Roberts & Co. (KKR), and Cherokee Investment Partners LLC, involves the purported misallocation of fees and expenses by fund advisers.

*Lincolnshire Management Inc.*: In September 2014, the SEC charged Lincolnshire with misallocating expenses between two portfolio companies. Lincolnshire integrated two portfolio companies, each owned by a different Lincolnshire-advised fund and comprised of different investors, and managed them as a single company. Although Lincolnshire owed a fiduciary duty to each fund, it caused one portfolio company to pay more than its proportionate share of the companies' joint expenses. Lincolnshire paid over $2.3 million in civil penalties, disgorgement and prejudgment interest to settle the action.

*KKR:* In June 2015, the SEC charged KKR with misallocating more than $17 million in "broken deal" expenses to its private equity funds in breach of its fiduciary duty to the funds. Broken deal expenses are diligence and other legal costs associated with unsuccessful buyout opportunities. These expenses are typically paid by the funds, but where co-investors and others contemplate investing alongside the funds, the expenses should be allocated among those that might benefit from the return on the potential investment.

The SEC found that KKR did not allocate any portion of the broken deal expenses to its own separate accounts, even though KKR intended to invest alongside the funds. KKR paid $30 million, including a $10 million penalty, to settle the matter.

*Cherokee Investment Partners:* In this matter, filed in November 2015, the SEC charged two private equity fund advisers with improperly allocating their own legal and compliance expenses to the funds they advised. The funds' organizational documents did not disclose that the funds would be charged such expenses, which included costs related to registration as an investment adviser, preparing for an examination by SEC staff, or responding to an SEC investigation. To settle the claims, the two Cherokee entities reimbursed the funds for the misallocated expenses and paid a $100,000 civil penalty to the SEC.

### Conflicts of Interest

The SEC also has brought two recent enforcement actions against fund advisers — Fenway Partners and LH Partners — for their purported failure to disclose conflicts of interest to their funds' limited partner advisory committee, or LPAC.

*Fenway Partners:* In this action, filed in November 2015, Fenway Partners entered into monitoring agreements with its portfolio companies and used the fees paid under those agreements to offset its management fees. Fenway, however, caused certain portfolio companies to terminate their monitoring agreements and enter into consulting agreements with an affiliated entity, Fenway Consulting (owned almost entirely by three of Fenway Partners' executives), which performed largely the same services as Fenway Partners through largely the same employees. The only difference was that the monitoring fee paid to Fenway Consulting was not offset against the Fenway Partners' management fee, causing the funds to pay more than they did under the prior arrangement. Fenway Partners did not disclose to investors or the LPAC the changes in the monitoring relationships. Fenway partners and four of its executives agreed collectively to pay over $10 million in penalties, disgorgement and prejudgment interest.

*JH Partners:* Also in November 2015, the SEC charged JH Partners with failing to disclose and to obtain fund advisory board consent for a number of transactions. Among other things, the adviser failed to disclose a series of loans to the funds' portfolio companies that resulted in JH Partners obtaining interests in those companies senior to the interests held by the funds. JH Partners also caused the funds it advised to invest in the same portfolio company at differing levels of priority, which would potentially favor one fund client over another. JH Partners paid a $225,000 civil penalty to settle the charges.

The SEC's enforcement actions and Ceresney's comments confirm that the SEC will aggressively continue to police private equity firms, particularly with respect to fee disclosure, expense allocation and conflicts of interest. Firms should carefully evaluate their compliance practices in these areas and others that could give rise to conflicts of interest.

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