CLIFFORD

CHANCE

Client briefing November 2015

SEC Pursues Expense Allocation and Disclosure Actions Against Private Fund Advisers

The US Securities and Exchange Commission ("**SEC**") is aggressively pursuing expense allocation and disclosure actions against private fund advisers and their personnel. The actions allege violations of the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") and the rules thereunder. Section 206 applies to both SEC-registered investment advisers and to "exempt reporting" advisers ("**ERAs**") relying on the private fund adviser exemption to avoid SEC registration. SEC-registered US and non-US advisers, as well as ERAs, should examine their current practices to prepare for further US regulatory scrutiny.

Recent Enforcement Activity

The SEC's Enforcement Division announced its focus on expense allocation and disclosure practices in 2013.[1] Since then, the SEC has brought an increasing number of actions against managers focused on expense allocation under the anti-fraud provisions in Advisers Act Section 206, which give rise to a fiduciary relationship between advisers and their clients. This duty requires advisers to, among other things, place each client's interest before their own. The SEC also interprets SEC Rule 206(4)-8 to establish a fiduciary-like standard for investment advisers with respect to their dealings with investors in the private funds that they advise. Advisers are also prohibited, absent adequate disclosure, from favoring one client over another. Although the SEC understands that some conflicts of interest are unavoidable, conflicts must be cured through appropriate disclosure, and, if necessary, by obtaining affirmative client consent.

SEC enforcement actions involving expense allocation often involve two related occurrences: (i) the adviser's compliance program fails to detect or mitigate a conflict of interest between the adviser and its clients; and (ii) the existing or potential conflict is not sufficiently disclosed to investors in the fund's formation documents or marketing materials. The SEC can take action against individuals and entities for violations of the Advisers Act and its rules, even if the alleged violation was unintentional.

---

1 Speech by Bruce Karpati, *Private Equity Enforcement Concerns* (Jan. 23, 2013) available at http://www.sec.gov/News/Speech/Detail/Speech/1365171492120.

Two recent SEC actions focus on the direct misallocation of expenses between managers and their funds. In both actions, the SEC claimed: (i) that the manager essentially double-charged clients by allocating certain overhead expenses to its funds that should have been paid for by the manager through the management fee; and (ii) that the manager failed to sufficiently disclose its allocation of operational expenses to the funds.

- **Improper Allocation of Operational and Non-Operational Expenses*.*** In a February 2014 complaint, the SEC alleged that Clean Energy Capital, LLC ("***Clean Energy***") and its CEO misappropriated more than $3 million from certain funds by causing the funds to pay expenses that the adviser should have paid.[2] According to the SEC, improperly allocated operational expenses included: (i) employee salaries, executive bonuses, health benefits, and retirement benefits; (ii) education and tuition costs for employees; (iii) employee hiring costs; (iv) maintenance costs for the manager's offices; (v) checks, letterhead, and business cards; and (vi) office and mobile telephone expenses. The SEC also alleged that the manager allocated expenses to its funds that were entirely unrelated to the manager's operations, such as transportation costs for the CEO's daughter and legal fees for estate planning. In an October 2014 settlement, Clean Energy and its CEO agreed to pay almost $2.3 million in disgorgement, interest, and penalties.[3]
- **Insufficient Disclosure of Allocated Expenses.** In April 2015, the SEC entered into settlements with Alpha Titans, LLC ("***Alpha Titans***") and its CEO and general counsel, as well as the manager's outside auditor.[4] The SEC alleged that the manager and its CEO used fund assets to pay the manager's operational expenses without sufficient disclosure, including: (i) employee salaries and health benefits; (ii) rent, parking, and utilities; (iii) computer equipment and technology services; and (iv) other operational costs. Alpha Titans and its CEO agreed to pay almost $700,000 in disgorgement, interest, and penalties under the settlement and certain executive officers consented to temporary bars from the securities industry.

While the Clean Energy and Alpha Titans orders present relatively straightforward manager/fund conflicts and deficient disclosures, more recent SEC actions focus on less direct fee and expense issues.

- **Undisclosed Portfolio Company Monitoring Fees.** In an October 2015 order against the Blackstone Group ("***Blackstone***"),[5] the SEC claimed that three managers entered into monitoring agreements with portfolio companies held by their funds to provide the companies with consulting and advisory services. Certain monitoring agreements allowed the managers to accelerate the payment of monthly fees by a portfolio company in the event of a private sale or IPO of the company. According to the SEC, the fee accelerations resulted in large payments to the managers that reduced the cash on a portfolio company's balance sheet when sold or taken public. The SEC claimed that this harmed investors by reducing the amount realized by the funds on their investments. Although the investment managers disclosed the accelerated payments to investors through distribution notices, quarterly management fee reports, and public filings, these disclosures were deemed insufficient by the SEC because they occurred *after* investors committed capital to the funds (*i.e.*, the disclosure was not made in the funds' offering documents). The SEC also alleged that the managers could not give effective consent on behalf of the funds to the managers' receipt of the accelerated fees, given the conflict. Blackstone agreed to pay nearly $39 million in disgorgement, interest, and penalties to settle the action.

[2] *In re Clean Energy Capital, LLC et al.*, SEC Release No. IA-3785 (Feb. 25, 2014) available at http://www.sec.gov/litigation/admin/2014/33-9551.pdf.
[3] *In re Clean Energy Capital, LLC et al.*, SEC Release No. IA-3955 (Oct. 17, 2014) available at https://www.sec.gov/litigation/admin/2014/33-9667.pdf.
[4] *In re Alpha Titans, LLC et al.*, SEC Release No. IA-4073 (Apr. 29, 2015) available at http://www.sec.gov/litigation/admin/2015/34-74828.pdf.
[5] *In re Blackstone Management Partners L.L.C., et al.*, SEC Release No. IA-4219 (Oct. 7, 2015) available at http://www.sec.gov/litigation/admin/2015/ia-4219.pdf.

- **Disparate Legal Fees.** The SEC also focused on a legal services arrangement that Blackstone negotiated on behalf of itself and its funds. The management companies allegedly received a substantially greater discount for "own account" legal work than the discount received by the funds managed by Blackstone and their portfolio companies. Although the managers identified this disparity through an internal audit, disclosed it, and equalized the fees, the SEC still identified the disparate legal fees rates as an Advisers Act violation.
- **Shifting Portfolio Company Service Providers.** In November 2015, the SEC settled an action with Fenway Partners, LLC ("***Fenway***")[6] and certain executive officers, alleging that Fenway caused fund portfolio companies to terminate management services agreements ("***MSAs***") with the manager, and then enter into more favorable "consulting agreements" with an affiliate. According to the SEC, this shift allowed the manager to collect additional undisclosed management fees from the funds, because, unlike fees paid to the manager under the MSAs, the consulting fees paid by portfolio companies to the manager's affiliate did not receive an 80% offset against the manager's advisory fee. The SEC also contended that the affiliate's consulting services were similar to the manager's services and often provided by the same employees. Fenway and its executive officers agreed to pay over $10 million in disgorgement, interest, and penalties to settle the action.

The SEC has also pursued enforcement actions against managers for improper expense allocations *between* advisory clients. Inter-client misallocations can involve the improper allocation of fees to portfolio companies (*see* Lincolnshire Management, Inc. ("***Lincolnshire***") settlement order),[7] or direct fee misallocations (*see* Kohlberg Kravis Roberts & Co. ("***KKR***") settlement order).[8]

- **Improper Allocation of Portfolio Company Expenses.** The SEC claimed in a September 2014 settlement with Lincolnshire that the manager misallocated expenses between portfolio companies owned by different funds. The portfolio companies shared a third-party payroll/401(k) administrator, but expenses for the administrator's services were only allocated to one portfolio company. This, the SEC alleged, resulted in the fund that owned that portfolio company (and ultimately its investors) paying more than its *pro rata* share of the administrator's fees. The SEC also claimed that other work that benefitted both portfolio companies was only allocated to one. There was no indication in the settlement documents that the manager intentionally allocated the expenses in this manner. Lincolnshire agreed to pay over $2.3 million in disgorgement, interest, and penalties.
- **Improper Allocation of Broken Deal Expenses.** The SEC settled an action against KKR in June 2015, alleging that the manager favored co-investors, including its own executives, by improperly allocating $338 million in broken deal and certain due diligence expenses exclusively to its funds. The manager had disclosed that the funds were responsible for "all" broken deal expenses incurred by, or on behalf of, the funds in developing, negotiating and structuring prospective or potential investments that were not ultimately made. However, the SEC claimed that the relevant offering materials failed to disclose the manager's practice of allocating broken deal expenses *solely* to the funds and not to co-investors, even though the co-investment vehicles participated in, and benefitted from, resulting transactions. KKR agreed to pay nearly $30 million in disgorgement, interest, and penalties.

---

6 *In re Fenway Partners, LLC, et al.*, SEC Release No. IA-4253 (Nov. 3, 2015) available at http://www.sec.gov/litigation/admin/2015/ia-4253.pdf.

7 *In re Lincolnshire Management, Inc.*, SEC Release No. IA-3927 (Sept. 22, 2014) available at http://www.sec.gov/litigation/admin/2014/ia-3927.pdf.

8 *In re Kohlberg Kravis Roberts & Co. L.P.*, SEC Release No. IA-4131 (June 29, 2015) available at http://www.sec.gov/litigation/admin/2015/ia-4131.pdf. The SEC also alleged in the Clean Energy order that the manager caused its funds to pay expenses on a pro rata basis, even though some expenses only related to specific funds.

Emerging Enforcement Trends

The SEC's recent expense allocation and disclosure actions are instructive for SEC-registered advisers and ERAs that want to mitigate their regulatory and enforcement risk. Managers should review these settlements closely as enforcement trends are emerging.

- **Individual Liability for Executives.** In line with its general enforcement strategy, the SEC is seeking to hold individual management personnel responsible for expense allocation and disclosure failures by a manager.
- **Investor Committee Consent.** Multiple SEC settlement orders state that a manager cannot consent to a conflict of interest on behalf of a fund, if the conflict exists directly between the manager and the fund. Thus, managers should exercise caution when resolving conflicts without consulting fund investor committees – particularly if a direct conflict exists.
- **Portfolio Companies Matter.** Fees paid, or reimbursed, by portfolio companies to the manager or its affiliates are just as critical to review as fees paid by the funds themselves. Arrangements involving the manager or its affiliates that could impact the value of a portfolio company should be disclosed and will likely require investor consent.
- **Written Policies and Procedures.** Managers should review their written supervisory policies and procedures governing fees, expense allocations, and conflict resolution, to confirm that they adhere to the SEC's evolving regulatory expectations and to current market practice.
- **Explicit and Consistent Disclosure.** The Alpha Titans order provides a useful roadmap of areas where managers can improve their disclosure practices in specific contexts:
  - **Private Placement Memoranda and Limited Partnership Agreements.** Managers that seek reimbursement from a fund for their own operational expenses, or for the operational expenses of an affiliate, must ensure that doing so is reasonable, and that the reimbursements are explicitly disclosed in the fund's offering materials. High level disclosure like "*The fund will pay a pro rata portion of certain operational, administrative, and other expenses of the General Partner that are incurred for the benefit of the Partnership*" is insufficient. Advisers should err on the side of specificity when disclosing potential fees.
  - **Form ADV Part 1 and Part 2.** Managers reimbursed by a fund for their own operational expenses, or for the operational expenses of an affiliate, should classify the reimbursements as additional "compensation". All compensation received by an SEC-registered adviser for advisory services should be disclosed in Item 5.E of Form ADV Part 1, and in Items 5.A and 6 of Form ADV Part 2.
  - **Audited Financial Statements to Investors.** The SEC has alleged violations of its rule governing custody of client assets (Rule 206(4)-2 under the Advisers Act) in expense allocation and disclosure actions. Compliance with Rule 206(4)-2 requires some managers to distribute GAAP-compliant financial statements to their investors. Financial statements may be deemed non-GAAP compliant (and thus a "custody" rule violation) if they fail to disclose operating expense reimbursements, or to properly characterize the reimbursements (*e.g.,* as related party transactions).
  - **Up-Front Disclosure Necessary.** There is little a manager can do to fix fee disclosures in older documents that were market when drafted, but are no longer specific enough to satisfy the SEC. For new funds, all direct and indirect expenses paid by a fund or a portfolio company should be explicitly disclosed in the offering documents. Post hoc disclosures through distribution notices, quarterly management fee reports, and public filings, are unlikely to be sufficient.

Conclusion

The pace of SEC enforcement actions against private fund managers and their executives has accelerated and is likely to continue. SEC-registered US and Non-US advisers, as well as ERAs, should undertake a review of their past and current expense allocation and disclosure practices. Fund managers must ensure that the fees and expenses they charge are fully disclosed to investors. Managers should also proactively identify expense allocation and disclosure issues, and, where possible, make adjustments to disclosures, agreements, and supervisory procedures. Managers may also need to consider reimbursing funds that paid inadequately disclosed expenses. The SEC has chosen to change market practice one enforcement action at a time in this area. Private equity, real estate, and hedge fund managers that do not react quickly to the changing landscape risk intense regulatory scrutiny of their current and past practices.

Authors

Steven Gatti
Partner

T: +1 202 912 5095
E: steven.gatti@cliffordchance.com

Jeff Berman
Partner

T: +1 212 878 3460
E: jeff.berman@cliffordchance.com

Clifford Cone
Partner

T: +1 212 878 3180
E: clifford.cone@cliffordchance.com

Robert Houck
Partner

T: +1 212 878 3224
E: robert.houck@cliffordchance.com

David Adams
Associate

T: +1 202 912 5067
E: davidg.adams@cliffordchance.com

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

Clifford Chance US LLP

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Jakarta* ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh ■ Rome ■ São Paulo ■ Seoul ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

*Linda Widyati & Partners in association with Clifford Chance.