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Allocating Fees and Expenses: The SEC Is Paying Close Attention

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I Introduction

In May 2014, the Director of the Office of Compliance Inspections and Examinations ("OCIE") at the Securities and Exchange Commission ("SEC") gave a speech to the Private Fund Compliance Forum to "share some insights we have learned from the examinations of private equity advisers".[1] The examinations referred to were part of OCIE's "presence exam initiative" that began approximately two years earlier as a result of the Dodd-Frank Act, and involved inspections and exams of more than 150 private equity advisers. The OCIE Director offered a number of observations from the examiners, but "by far, the most common observation" concerned the allocation of fees and expenses by advisers. Specifically, the OCIE Director noted that examiners had found "violations of law or material weaknesses in controls *over 50% of the time*". The SEC staff saw improper fee and expense allocation as no accident, but rather as an attempt by private equity advisers to make up for tighter margins and industry consolidation that put downward pressures on percentage-based management fees.

The 2014 OCIE Director's speech signalled an increased focus by the SEC on issues related to fees and expenses and related conflicts of interest, which is ongoing and evolving. Subsequent comments by SEC officials, as well as a number of enforcement actions, demonstrate that the SEC continues to refine its approach as it becomes more familiar with the industry. Set out below is an overview and analysis of the current enforcement landscape and some general recommendations on how to manage the risk of increased scrutiny.

II Enforcement Trends

The OCIE Director in 2014 identified several specific areas of concern with respect to fees and expenses and related conflicts of interest:

- **Fee and expense shifting**: adviser fees and expenses, such as back office functions, charged to the funds, or generally applicable fees and expenses charged only to the main fund, and not other fund vehicles, such as co-investment vehicles.
- **Hidden fees and expenses**: undisclosed fees and expenses charged directly to portfolio companies, often in the form of "operating partner", consulting, and monitoring agreements.
- **General lack of disclosure**: poorly or vaguely described expense and fee shifting arrangements, as well as poorly or vaguely described potential conflicts of interest between the adviser and its funds regarding the amounts and types of fees and expenses.

Standing alone, these areas of concern were fairly unremarkable. SEC-registered advisers are already obligated to disclose the material terms of their fund agreements and to avoid hiding fees and expenses or conflicts of interest from investors. What was not immediately apparent at the time, however, was the level of scrutiny that the SEC would apply to fee and expense allocations, disclosures, and third-party arrangements to identify what the SEC believes to be improper practices. Through the many Enforcement Division settlements described below, the SEC appears particularly focused on making sure that investors are fully aware of fee and expense allocation practices, whatever they may be, at a relatively high degree of granularity and before they commit to investing in the funds. The wide variety of scenarios indicates that the SEC is looking to demonstrate the applicability of this principle to broad areas of fund activities and finances. Illustrative settlements include the following:

- *In the Matter of Clean Energy Capital LLC* (25 February 2014): The SEC charged Clean Energy with improperly charging more than $3 million of the adviser's expenses to the funds. In addition to charging the funds for adviser expenses such as "rent, salaries, and other employee benefits such as tuition costs, retirement, and bonuses", the adviser's CEO lent money to the funds "at unfavorable interest rates" when the funds began to run low on cash.[2] According to the SEC, these constituted wilful violations of federal anti-fraud laws, in addition to violations of laws related to disclosure, compliance, custody, and reporting. Respondents were ordered to disgorge more than $2 million and pay civil fines in the amount of $225,000.[3]
- *In the Matter of Lincolnshire Management, Inc.* (22 September 2014): The SEC charged Lincolnshire, the adviser, for failing to implement or follow a clear allocation policy for fees and expenses related to two merged portfolio companies held by parallel funds. While "[t]he two companies integrated a number of business and operational functions, including payroll and 401(k) administration, human resources, marketing, and technology", and "shared numerous annual expenses", there were times when one company (or the other) would bear the entirety of what should have been a shared cost – e.g., third-party payroll expenses, certain shared overheads, and salaries and bonuses for certain shared employees.[4] This *ad hoc*, and often undocumented, allocation of expenses led to more than $1.8 million in disgorgement and prejudgment interest and a civil penalty of $450,000 for failures "to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (the "Advisers Act") arising from the integration of the two portfolio companies".[5]
- *In the Matter of Alpha Titans, L.L.C.* (29 April 2015): The SEC charged Alpha Titans and its auditor for improperly charging the funds for adviser-related expenses and operational costs,

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such as salaries, health benefits, parking and technology services. While the offering memoranda disclosed that the funds would "bear[] all the expenses incurred by it or by others on its behalf or for its benefit, including ordinary operational and administrative expenses", the SEC noted that it disclosed nothing about the "cost of any of Alpha Titans' operational and administrative expenses".[6] This cursory language stood in contrast to the more exhaustive disclosures that had been made to the funds' earlier investors. Similarly, Alpha Titans' Forms ADV did not disclose operational expenses as part of its compensation or fees and instead referred only to its management fee, based on the percentage of assets. According to the SEC: "Alpha Titans did not make the proper disclosures for clients to decipher that the funds were footing the bill for many of the firm's operational expenses."[7] Over the course of four years, the adviser misallocated more than $450,000 towards its own operational and administrative expenses and was ordered to disgorge around $500,000 and pay $200,000 in civil fines.[8]

- *In the Matter of Kohlberg Kravis Roberts & Co., L.P.* (29 June 2015): The SEC charged Kohlberg Kravis Roberts & Co., Inc. ("KKR") with violations of the Advisers Act for failing to disclose that certain co-investment vehicles did not bear a portion of "broken deal expenses" that were generally borne by KKR's other funds. According to the SEC order, KKR's "Flagship" funds are entitled to invest a minimum amount in any portfolio investment within the applicable strategy as defined in the fund's organic documents. Certain "KKR Co-Investors", consisting of funds holding investments by KKR executives, consultants and "others", as well as co-investment vehicles, were generally offered the opportunity to invest (or in certain cases, committed to invest) in KKR's portfolio investments alongside the Flagship funds. Finally, from time to time, KKR would syndicate additional investment opportunities on a transaction-by-transaction basis from additional third-party investors.

  The limited partnership agreements of KKR's funds required the funds to bear all "broken deal expenses" incurred "on or behalf of" the fund in sourcing and making investments. (Such investments include research, travel, and professional costs incurred in connection with transactions that are not consummated.) Generally speaking, KKR's funds bore 80% of broken deal expenses, while KKR bore 20% of broken deal expenses. However, until 1 January 2012, the "KKR Co-Investors" that invested alongside the KKR funds in the ordinary course were not allocated, and generally did not bear, broken deal expenses, other than about $333,500 in broken deal expenses allocated to such vehicles in December 2011.

  In the course of an OCIE inspection in 2013–2014, KKR determined to refund its Flagship funds about $3.26 million in broken deal expenses. According to the SEC, KKR misallocated to the Flagship funds a net total of $17.4 million in expenses that should have been borne by the KKR Co-Investors in accordance with the post-January 2012 methodology. The SEC stated that this misallocation flowed from KKR's failure to establish a written policy governing allocation of expenses to co-investors prior to 1 January 2012, and lacking "[a] robust compliance program [that] helps investment advisers ensure that clients are not disadvantaged and receive full disclosure about how fund expenses are allocated".[9] The SEC ordered KKR to cease and desist from violations of Sections 206(2) and 206(4) of the Advisers Act, pay a total of $18,677,409 ($14,165,968 in principal and $4,511,441 in interest) in disgorgement to the Flagship funds to compensate them for the misallocated expenses, and a civil monetary penalty of $10 million.[10]

- *In the Matter of Taberna Capital Management, L.L.C.* (2 September 2015): The SEC charged Taberna Capital Management for fraudulently retaining over $15 million in "exchange fees" that belonged to the collateralised debt obligations ("CDOs") that Taberna managed. According to the SEC: "Taberna secretly diverted funds owed to CDO clients, and concealed that diversion and the conflicts it created."[11] Exchange fees were paid by the issuer upon the exchange of the CDO's assets, but Taberna would classify these fees as "third party costs incurred" despite the fact that there were few actual third-party costs incurred. The SEC stated that this reflected a deliberate attempt to "obscure the nature of the fees".[12] The SEC further pointed out that by retaining exchange fees, the adviser had an undisclosed conflict of interest in pursuing exchange transactions, whether or not they were in the best interests of the CDO. Taberna agreed to pay disgorgement of $13 million (on top of $2 million it had already paid), pre-judgment interest of $2 million, and a penalty of $6.5 million, and not to act as an investment adviser for three years. Taberna's former managing director and chief operating officer also paid fines for violations of the Advisers Act.[13]

- *In the Matter of Blackstone Management Partners L.L.C., et al.* (7 October 2015): The SEC charged Blackstone with violations of the Advisers Act in connection with accelerating certain fees payable from its portfolio companies upon a sale or initial public offering ("IPO") of a portfolio company.[14] As is common industry practice, Blackstone entered into monitoring agreements with certain of its portfolio companies under which it charged the portfolio companies a monitoring fee. Upon the sale or IPO of a portfolio company, the agreements provided that the remaining years of annual fees would be accelerated and paid to Blackstone in a lump sum. The relevant fund agreements provided that the fees Blackstone received would partially offset the management fees on the funds paid to Blackstone, and as a result, the funds gained some of the economic benefits of the accelerated fees. According to the SEC, while the relevant fund agreements disclosed that Blackstone charged monitoring fees, Blackstone's practice of accelerating monitoring fees was not disclosed until after the fact, in various distribution notices, quarterly reports, and Form S-1 filings for IPOs. The SEC noted that Blackstone had cooperated in the staff's investigation and had taken remedial measures, including additional disclosures and limits regarding accelerated fees. Blackstone agreed to pay disgorgement in the amount of $28,911,756 (including both principal and interest) and a civil monetary penalty of $10,000,000.[15]

- *In the Matter of Fenway Partners, LLC, et al.* (3 November 2015): The SEC charged Fenway Partners, a registered investment adviser, three of its controlling members, and its chief compliance officer with violations of Sections 206(2) and 206(4) of the Advisers Act for entering into conflicted transactions that allowed the controlling members of Fenway Partners to benefit from portfolio company monitoring fees without sharing the benefit of the fees with the private funds. According to the SEC: "Fenway Partners and its principals breached their fiduciary obligation to fully and fairly disclose conflicted arrangements to a fund client, and compounded the breach by omitting material facts about the arrangements when communicating with fund investors."[16]

  Like other private equity funds, Fenway Partners received monitoring fees from its portfolio companies. The organisational documents of its funds provided that 80% of such fees received would offset the management fees the funds owed to Fenway Partners. Beginning in 2011, Fenway caused its portfolio companies to terminate their monitoring fee arrangements with Fenway Partners, and enter into new arrangements with Fenway Consultants, an affiliated entity owned by Fenway Partners' controlling members. Unlike the fees paid to Fenway Partners, the fees paid to Fenway Consultants (totalling $5.74 million) were not offset against the management fees that the funds owed to Fenway Partners. The conflict of interest posed by Fenway Consultants being owned by the owners of Fenway Partners was not disclosed

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to the funds or their limited partners. Fenway also caused a portfolio company to issue a capital call in part to pay a $1 million fee to Fenway Consulting, and a portfolio company paid to Fenway Partners' controlling members a substantial cash incentive payment (totalling $15 million) not to offset against management fees the funds owed to Fenway Partners or disclosed to the funds.

The SEC charged Fenway Partners and the controlling members with wilful violations of the Advisers Act by engaging in transactions that "operated as a fraud or deceit", and the chief compliance office with "causing" a violation of the Advisers Act. The SEC ordered Fenway Partners and the individuals to cease and desist from violations of the Advisers Act, pay a total of $8,716,471.10 in disgorgement and a total of $1,525,000 in civil penalties.[17]

- *In the Matter of Cherokee Investment Partners, LLC and Cherokee Advisers, LLC* (5 November 2015): The SEC charged Cherokee with violations of Sections 206(4) and 206(6) of the Advisers Act for allocating certain legal and compliance expenses of the adviser to its private equity funds. In connection with Cherokee's initial registration under the Advisers Act and compliance with the Act's requirements, Cherokee caused its funds to bear more than $170,000 in legal and consulting fees. Cherokee also caused its funds to bear over $239,000 in expenses which Cherokee incurred in connection with an SEC staff review, and over $45,000 in expenses flowing from the SEC staff's enforcement investigation. While the applicable partnership agreements disclosed that the funds "would be charged for expenses that in the good faith judgment of the general partners arose out of the operation and activities of the funds", they did not disclose that the funds would bear a portion of the adviser's legal and compliance expenses.[18] The SEC also alleged that Cherokee failed to adopt written policies or procedures reasonably designed to prevent violations of the Advisers Act through such expense allocations, and that Cherokee failed to review its policies to ensure their adequacy and effectiveness.

  In March 2015, Cherokee ceased allocating these expenses to its funds, and, in April 2015, reimbursed them for "the full amount of the [misallocated] expenses". The SEC noted that it "considered remedial acts taken by Respondents and cooperation afforded the Commission staff" in agreeing to accept Cherokee's offer to pay a civil monetary penalty of $100,000 to the SEC, and to cease and desist from violations of Sections 206(2) and 206(4) of the Advisers Act and rules thereunder.

- *In the Matter of Cranshire Capital Advisors, LLC* (23 November 2015): The SEC charged Cranshire Capital Advisors, a registered advisor, for negligently allocating management company expenses to its private equity fund. The offering memoranda disclosed that "operating expenses (such as rent for office space and telephone lines)" would be borne by the advisor, while the fund would "pay all its other expenses, including [...] legal and accounting fees".[19] Cranshire used about $118,000 in fund assets to cover overhead expenses and about $158,000 in fund assets to pay the fees of a compliance consultant. The SEC alleged that the improper allocation was caused by Cranshire's failure to adopt and implement an adequate compliance programme, and to adequately monitor allocation of expenses. Cranshire engaged a new compliance consultant in 2014, and reimbursed the funds for the misallocated expenses.

  The SEC mandated that Cranshire continue to employ the compliance consultant, cease and desist from violations of Sections 206(2) and 206(4) of the Advisers Act, and to pay a civil money penalty of $250,000. The SEC noted that it "considered [Cranshire's] remedial acts [...] and cooperation afforded the Commission staff".[20]

- *In the Matter of JH Partners, LLC* (23 November 2015): The SEC found that JH Partners and certain of its principals had taken a number of actions without the consent of the private equity funds' advisory boards, despite clear requirements in the applicable partnership agreements to obtain consent. For example, JH Partners loaned approximately $62 million to portfolio companies that effectively gave the adviser a senior interest in those companies. The adviser also caused certain funds to invest in the same portfolio company at differing levels in the company's capital structure and at differing valuations, both of which created the possibility of a conflict of interest. The adviser also exceeded certain concentration limits disclosed in the private equity funds' partnership agreements. Direct loans, cross-investments, and investments in excess of concentration limits all required the consent of the advisory boards, which the adviser did not obtain.

  Following an SEC examination, JH Partners "agreed to subordinate (or place in equal footing) the direct loans to the Funds' investment interests [...], forego any rights to pursue repayment under the security agreements on certain loans [...] and waive[] $24 million in management fees and carried interest".[21] JH Partners also obtained the necessary consents of the advisory boards. While the SEC did not allege that the adviser benefited from these conflicts of interest, it nonetheless charged the adviser with violations of Section 206, because the adviser's actions violated the partnership agreements, and ordered JH Partners to pay a civil fine of $225,000.[22]

- *In the Matter of Apollo Management V, L.P., et al.* (23 August 2016): The SEC charged Apollo with violations of the Advisers Act in connection with accelerating certain fees payable from its portfolio companies either upon private sale or IPO of portfolio companies, a loan between an Apollo management company and one of its managed funds, and in connection with a former senior partner's improper charging of personal expenses to the fund.

  Following common industry practice, Apollo entered into monitoring agreements with certain of its portfolio companies under which it charged the portfolio company a monitoring fee. When a portfolio company was sold or completed an IPO, the monitoring agreements provided that the remaining years of annual fees would be accelerated and that the present value of the remaining fees would be paid as a lump sum. Under the relevant fund agreements, fees paid to Apollo would partially offset a percentage of the management fees that the funds would otherwise pay to Apollo, meaning that the funds also received some of the benefit of the accelerated fees. While the SEC noted that Apollo had disclosed that it received monitoring fees, the SEC alleged that Apollo had not adequately disclosed the practice of receiving accelerated monitoring fees until after Apollo had already taken the accelerated fees.

  Separately, certain Apollo funds extended an approximately $19 million loan to Apollo Advisors VI, L.P., the funds' management company, with the effect of deferring taxes owed on carried interest due to the management company from the funds. The loan required the management company to pay interest to the lending funds at the applicable federal rate of 3.45% per year. According to the SEC, while the loan and interest accrued was reflected on the funds' financial statements, Apollo failed to disclose that the interest received on the loan would be allocated solely to the account of the management company. Finally, the SEC charged Apollo with deficiencies in its written policies and procedures that failed to prevent a former senior partner from improperly charging certain personal expenses to the funds.

  The SEC noted that Apollo had cooperated in the staff's investigation, had commenced an investigation into the former partners' improper expenses, that the former partner had reimbursed Apollo for the improper expenses, and that Apollo had voluntarily reported to the SEC that the former partner had charged personal expenses to the fund. Apollo agreed to pay disgorgement in the amount of $40,254,552

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(including both principal and interest) for the amounts of accelerated monitoring fees and to compensate the funds that had extended the loan to Apollo Advisors VI for the interest allocated to the fund, as well as a civil monetary penalty of $12,500,000.[23]

- *In the Matter of WL Ross & Co. LLC* (24 August 2016): The SEC charged WL Ross with omitting material information regarding its allocation of transaction fees in violation of Section 206(2) and 206(4) of the Advisers Act. Under the applicable fund agreements, WL Ross's managed funds paid WL Ross a management fee, which fee would be offset by 50% of any of a number of transaction fees (e.g., break-up fees or monitoring fees) received by WL Ross. Beginning in 2001, WL Ross allocated transaction fees to its managed funds *pro rata* based upon the funds' investment in the relevant portfolio company, while WL Ross retained the portion of fees attributable to co-investors' investment in a portfolio company, with the effect of providing WL Ross with approximately $10.4 million in additional fees from 2001 through 2011. According to the SEC, WL Ross failed to disclose to the funds, their advisory boards, or their limited partners that WL Ross was so allocating transaction fees.

  In the course of a 2014 OCIE investigation, WL Ross revisited its transaction fee allocation methodology and, in August 2014, brought its allocation methodology to the attention of OCIE staff. The SEC noted that WL Ross voluntarily proposed and adopted a new methodology that allocated all transaction fees across its managed funds, retroactively applied this methodology to past transaction fees, and voluntarily reimbursed the funds for approximately $10.4 million of transaction fees and $1.4 million in interest. WL Ross also voluntarily enhanced its internal controls and compliance functions, including by hiring a new Chief Compliance Officer. WL Ross agreed to pay a civil monetary penalty of $2.3 million.

- *In the Matter of First Reserve Management, L.P.* (14 September 2016): The SEC charged First Reserve Management, a registered investment advisor and manager of a series of private equity funds, for causing its managed funds to bear certain expenses on behalf of the management company and failing to share the benefit of a discount offered to the management company. In 2013, a First Reserve affiliate caused certain First Reserve funds to form and bear approximately $7.4 million in expenses of certain advisor entities that the management company would otherwise have borne, and to pay $733,012 in insurance premiums for First Reserve's liability insurance for risks that do not arise from its management of the funds. First Reserve also, between 2010 and 2014, negotiated a fee discount from an outside law firm for work done for the management company, on the basis of work that the firm had done and would continue to do for the managed funds. First Reserve did not obtain a similar discount for the work done for the managed funds, and did not disclose to the funds or the funds' investors that it had obtained a discount which benefited the management company. In the course of a 2014 OCIE investigation, First Reserve voluntarily reimbursed the expenses improperly charged to the funds, and approximately $179,466 attributable to the legal fee discount. First Reserve agreed to pay a civil monetary penalty of $3.5 million.

Looking back, several key lessons emerge from these settlements.

First, the SEC does not limit its review to smaller shops or firms with primarily "unsophisticated" investors; indeed, the SEC has reached settlements with some of the largest firms in the industry. The private equity sector had long avoided intense regulatory scrutiny because private equity investors were considered sophisticated enough to police advisers themselves. The SEC signalled at the outset of this enforcement push that it is no longer operating on that assumption, pointing out that "'Mom and Pop' are much more invested in these funds than people realize".[24] The SEC's actions have demonstrated that its enforcement priority is unaffected by the relative sophistication of the parties. Indeed, part of the problem, according to the SEC, is that partnership agreements and disclosure documents provide insufficient insight into fund operations, making oversight difficult even for sophisticated investors. In addition, the SEC has not been persuaded by the argument that sophisticated investors might view certain allocation issues as immaterial or that they might have gained actual knowledge of the adviser's practices. Rather, the SEC has focused on fund agreements and disclosure documents reviewed by investors *at the time they decided to make their initial commitments to a fund* – and far less on disclosures issued after commitments are already made. In a May 2016 speech, the then director of the Enforcement Division, Andrew Ceresney, explained that it was "critically important that advisors disclose all material information, including conflicts of interest, to investors *at the time their capital is committed*".[25] In particular, Ceresney noted that the long capital commitments – in some cases 10 years or more – limit investors' ability to change course based on information learned after an initial investment decision. This corresponds to Bowden's observation that "[w]hile investors typically conduct substantial due diligence *before* investing in a fund, [staff] have seen that investor oversight is generally much more lax *after* closing",[26] and has been reiterated by the SEC's finding that advisory boards and investors cannot give effective consent unless allocation practices are known before the fees are received or expenses are incurred.

Second, the language of the disclosure really matters. Although industry practices are evolving, many firms' limited partnership agreements delegate substantial discretion to a general partner to determine the kinds of expenses that will be borne by the private equity funds, and some provide a "catch-all" provision that gives the general partner discretion to adjust the allocation among funds or between the manager and funds. In our experience, the overwhelming majority of managers have sought to allocate expenses equitably and these broad provisions may continue to serve a helpful function in private equity fund partnership agreements. Nonetheless, the SEC has signalled that investors must be given greater detail regarding the mechanics of how, when, why and in what amounts fees and expenses are allocated between the funds and the adviser, and between the funds themselves. That includes operating expenses, reimbursements, offsets, broken deal expenses, consulting fees, compliance expenses, and any fee or expense that could plausibly be construed as an expense properly borne by the adviser rather than the funds. Whether in the partnership agreement or in private placement memoranda, the mechanics of allocation should be disclosed upfront and in as much detail as is reasonably practicable. On a related note, allocation mechanisms or expense-sharing rules may well vary across funds or during a fund's lifecycle for business reasons. While this is not at all impermissible *per se*, it will be important to develop a clearly articulated reason for any disparities or changes and to disclose such potential disparities and changes to investors (and gain their consent, when necessary).

Potential conflicts of interest should also be precisely disclosed, particularly where the conflict includes an opportunity to shift fees and expenses to portfolio companies and out of investors' direct line of sight. The SEC has put the burden on advisers to inform investors, rather than wait until investors discover these issues on their own. As the Acting Director of OCIE remarked in March 2015, "[m]any managers still seem to take the [erroneous] position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty".[27]

Third, compliance with established procedures really matters. Policies and procedures must be followed closely, even where investors have not necessarily been harmed. If a written fee income

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or expense allocation policy is not yet in place, now is the time to prepare such a policy, ensuring that it precisely tracks the operative agreements and can be followed as a matter of course. The actions described above suggest that advisers run into danger when non-ordinary course income or expenses arise and employees are forced to make *ad hoc* allocation decisions without prior disclosure or a pre-existing policy to justify these decisions in a later SEC examination. Moreover, the SEC is enforcing policies strictly even though it is cognizant of the fact that it is asking advisers to thread the needle between exhaustive disclosures and adhering to those disclosures, even in the face of changing or unexpected circumstances. In the context of co-investment allocations, the Acting Director of OCIE in 2015 noted: "[M]any in the industry have responded to our focus by disclosing less [...] rather than more under the theory that if an adviser does not promise their investors anything, that adviser cannot be held to account [...]. [However,] I believe that the best way to avoid this risk is to have a robust and detailed co-investment allocation policy which is shared with all investors [...] all investors deserve to know where they stand in the co-investment priority stack."[28] The same could also be said about fee and expense allocation procedures, generally.[29]

Fourth, the SEC is taking a risk-weighted approach to determine its exam targets. Certain practices have invited more scrutiny than others, and the SEC has aggressively pursued issues that arise on exam. The Acting Director of OCIE in 2015 acknowledged the SEC's "risk-based exam selection process" but did not offer much detail, noting only that "we identify situations or behaviors which pose significant risk to investors or which, we believe, may violate federal securities laws and regulations".[30] In 2016, the then Director of the Enforcement Division grouped actions against private equity advisors into three categories: "undisclosed fees and expenses"; "impermissibl[e] shift[s] in fees and expenses" and "fail[ing] to adequately disclose conflicts of interest, including conflicts arising from fee and expense issues."[31] Based on these public statements and Enforcement's track record in the private equity space over the past several years, it appears these issues often relate to co-investments (and related expenses), and third-party arrangements (and related expenses), such as operating partner agreements, monitoring agreements, and outside counsel (and related expenses). The Acting Director of OCIE in 2015 stated explicitly that the SEC had become more focused on co-investment allocation because it had "becom[e] a key part of an investor's thesis".[32] Fee and expense allocation for co-investment vehicles is often complex, and the SEC has indicated that it has little patience for policies and procedures that do not reflect that complexity. With respect to third-party arrangements, the SEC has been focused on the potential for "back-door" and other unseen fees and expenses charged to the portfolio companies and/or shifted from the adviser. The SEC has recently referred to these kinds of shifted or hidden fees as front- and back-office "outsourcing".[33] These issues are particularly ripe in vertically integrated advisory firms, such as real estate advisers, where "it is not unusual for [...] [an] owner-operator investment adviser to provide property management, construction management, and leasing services for additional fees".[34]

III Moving Forward

Increased oversight of private equity firms will continue for the foreseeable future.[35] The SEC continues to invest resources to learn about the industry, and its approach will evolve accordingly. The SEC has established a Private Funds Unit ("PFU") that "plays a critical role in targeting and selecting exam candidates, scoping risk areas, executing examinations, and analyzing data gleaned from those examinations".[36] The PFU is unique in that it straddles different regional offices and is designed to share information and expertise across the agency and with other examiners.

There are a number of steps that advisers can take to manage the risk of inspections and improve compliance going forward:

- **Offering Documents**: If there is one lesson the SEC wants the private equity industry to learn, it is that the industry must improve its disclosures with respect to fee and expense allocation, and potential conflicts of interest. The disclosure bar has been raised, especially when fees and expenses involve third parties, and/or where fees and expenses are borne by portfolio companies. While these arrangements are not *per se* problematic, disclosures must be clear about what these expenses are and whether, and to what extent, they will be paid by the funds. If the fee structure or third-party arrangement creates any incentives for the adviser to pursue a particular approach, or otherwise creates a potential conflict, such as acceleration payments, differential rates, or transaction costs, these must also be clearly disclosed. If there is a co-investment vehicle involved, or other side-by-side investments, any differential treatment or offset arrangement must similarly be spelled out.
- **Other Disclosures**: While it is critical to include adequate disclosures in the fund documents, the Form ADV can also be used to help inform investors regarding policies and procedures. Similarly, limited partner advisory committees can be actively engaged, and it may also make sense to expand approval rights of these committees to obtain investor consent on certain allocation decisions that deviate from established practices.
- **Compliance**: Precisely described policies and procedures will require robust compliance programmes to ensure that policies and procedures are documented and followed. A robust compliance function will also help detect undisclosed potential conflicts of interest that may require additional policies and procedures, investor approvals, or disclosures. It is critical that compliance be sufficiently independent, knowledgeable and engaged to fulfil its responsibilities. As former SEC Chair Mary Jo White commented: "[Registrants] can draw on external [compliance] assistance, but [they] cannot outsource [their] obligations. Regardless of the structure, each registrant is ultimately responsible for adopting and implementing an effective compliance program and is accountable for its own deficiencies."[37]
- **Back Office**: Policies and procedures – particularly those with complex fee or cost allocation arrangements – must be supported by a robust back office that is capable of allocating costs correctly and consistently, as well as maintaining the proper documentation of allocations. This is especially critical when similarly situated funds or groups of investors seem to be treated differently.
- **Preparation for Exams**: Advisers should carefully prepare for exams by OCIE, which are increasingly comprehensive and thorough. Advisers should expect that OCIE examiners will carefully review provisions in fund agreements and policies and procedures relating to expense and fee allocations. The OCIE team will also inquire into instances where allocations may not have been made consistent with disclosures or in a way which disadvantages fund investors. In the course of its work, OCIE may request from the adviser categories of emails and other internal communications, as well as conduct interviews with personnel of all seniority levels, to test compliance with the securities laws and regulations. Given the nature of the exam process, advisers should prepare carefully to ensure a smooth process and positive outcome.
- **Self-Reporting**: The SEC has stressed that it has no desire to play "gotcha", even while its enforcement focus on private equity firms persists and evolves, and the SEC has made a pointed effort to reach out to the industry and seek its cooperation and input.[38] Similarly, in its various enforcement

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actions, the SEC has cited with approval the cooperation of respondents and any proactive remedial actions. One open question, however, is whether and to what extent the SEC will alter its approach in the event of a self-reported issue. In announcing one settlement described above, the SEC stated that "[t]he Division of Enforcement's Asset Management Unit [...] encourages private equity fund advisers [...] to self-report [fee and expense issues] to the staff. As noted in the Division of Enforcement's Enforcement Manual, self-reporting is one factor that the Commission considers when evaluating cooperation and determining whether and to what extent to extend credit in settlements".[39] It should be noted that self-reporting may not result in the avoidance of a charge altogether, but rather, based on the circumstances, in a mitigation of the charges and/or penalties, as was observed in the settlement involving WL Ross. Thus, a decision to self-report should be taken after careful consideration and consultation with counsel.

IV Conclusion

As the SEC continues its enhanced examination and enforcement activity in the private equity sector, fund managers have been grappling with redefined expectations and practice in the disclosure of allocations of fees and expenses and conflicts of interest generally. While the ground is still shifting, there are a number of concrete steps managers can take to bolster their compliance, including reviewing and improving relevant disclosures, ensuring robust compliance policies and procedures, and beefing up compliance infrastructure and resources.

Endnotes

1. *Spreading Sunshine in Private Equity*, Andrew J. Bowden (6 May 2014) ("Bowden Speech") *available at* https://www.sec.gov/News/Speech/Detail/Speech/1370541735361.
2. Press Release 2014-41 *available at* https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540849548.
3. *In re Clean Energy Capital, L.L.C., et al.*, File No. 3-15766 (24 February 2014).
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5. *In re Lincolnshire Management, Inc.*, File No. 3-16139 (22 September 2014).
6. Press Release 2015-76 *available at* https://www.sec.gov/news/pressrelease/2015-76.html.
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8. *In re Alpha Titans, LLC et al.*, File No. 3-16520 (29 April 2015).
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11. Press Release 2015-177 *available at* https://www.sec.gov/news/pressrelease/2015-177.html.
12. *In re Taberna Capital Management, L.L.C., et al.*, File No. 3-16776 (2 September 2015).
13. *Id.*
14. Press Release 2015-235 *available at* https://www.sec.gov/news/pressrelease/2015-235.html.
15. *In re Blackstone Management Partners L.L.C., et al.*, File No. 3-16887 (7 October 2015).
16. Press Release 2015-250 *available at* https://www.sec.gov/news/pressrelease/2015-250.html.
17. *In re Fenway Partners, LLC, et al.*, File No. 3-16938 (3 November 2015).
18. *In re Cherokee Investment Partners, LLC, et al.*, File No. 3-16945 (5 November 2015).
19. *In re Cranshire Capital Advisors, LLC*, File No. 3-16969 (23 November 2015).
20. *Id.*
21. *In re JH Partners, LLC*, File No. 3-16968 (23 November 2015).
22. *Id.*
23. *In re Apollo Management V, L.P., et al.*, File No. 3-17409 (23 August 2016).
24. *Bowden Speech.*
25. Securities Enforcement Forum West 2016, Keynote Address: Private Equity Enforcement, Andrew Ceresney (12 May 2016).
26. *Id.*
27. *Private Equity: A Look Back and a Glimpse Ahead*, Marc Wyatt (13 May 2015) ("Wyatt Speech") *available at* https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.
28. *Id.*
29. The potential conflicts of interest arising from fee and expense allocation are an issue of broader SEC enforcement focus. For example, in 2016 the SEC charged James Caird Asset Management LLP and its principal with violations of Section 206(2) of the Advisers Act for failing to follow a disclosed investment policy of a multi-strategy fund and a distressed opportunities fund by allocating to the distressed fund portions of certain investments of the muti-strategy fund, against the backdrop of the management company principal's significant ownership stake in the distressed fund and relatively smaller stake in the multi-strategy fund. *See In the Matter of James Caird Asset Management LLP and Timonthy G. Leslie*, File No. 3-17276 (2 June 2016).
30. *Id.*
31. Securities Enforcement Forum West 2016, Keynote Address: Private Equity Enforcement, Andrew Ceresney (12 May 2016).
32. *Id.*
33. *Compliance Outreach Program – 2016 National Seminar for Investment Adviser and Investment Company Senior Officers* (7 April 2016) ("2016 Compliance Outreach Program") available at https://www.sec.gov/info/complianceoutreach/compliance-outreach-program-national-seminar-2016.htm.
34. *Wyatt Speech.*
35. *2016 Compliance Outreach Program.*
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37. *Opening Remarks at the Compliance Outreach Program for Investment Companies and Investment Advisers*, Mary Jo White (19 April 2016) available at https://www.sec.gov/news/statement/chair-white-statement-compliance-outreach-ic-ia-041916.html.
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