JACKO LAW GROUP, PC

Legal Risk Management Tip
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PRIVATE EQUITY – 2015 ENFORCEMENT SUMMARY AND WHAT TO EXPECT IN 2016

A Focus on Private Equity

The past year has seen interesting developments for private equity funds and, in many cases, their recently registered investment advisers. Ever since Andrew Bowden's "Spreading Sunshine in Private Equity" speech[1] that announced private equity's emergence as a focus area for the Securities and Exchange Commission ("SEC"), the industry has seen a steady increase in the amount of regulatory attention and scrutiny on private equity advisers and funds.[2] While much of the focus has centered on fees and expenses, other important compliance areas are certainly fodder for the SEC's Division of Enforcement.

Below is a summary of select enforcement cases that focused on private equity issues during 2015, and a brief discussion of what we expect lies ahead for private equity participants in 2016.

Summary of Select 2015 Private Equity Enforcement Actions

1. In the Matter of Kohlberg Kravis Roberts & Co., L.P.[3]

KKR paid $30,000,000 to settle charges that it breached its fiduciary duty to investors in its flagship fund by misallocating broken deal expenses to them. During the period from 2006 – 2011, KKR allocated approximately $17.4 million of broken deal expenses (for due diligence research, travel and other expenses) incurred relating to buyout transactions that did not proceed. In addition, KKR did not generally charge such broken deal fees to KKR co-investors, even though such co-investors benefited from KKR's sourcing of private equity transactions. This practice was not expressly disclosed in the relevant KKR offering materials, and KKR did not have a written policy governing its broken deal fee allocation practices until 2011. The SEC determined that KKR did not adequately disclose its allocation of broken deal expenses in limited partnership agreements or in other disclosure and offering materials. Also, the SEC stated that KKR failed to implement written policies and procedures governing broken deal expense allocation during the period from when it registered with the SEC as an investment adviser in 2008 – 2011. As a result, KKR paid disgorgement and prejudgment interest of $18,677,409 and a civil money penalty of $10,000,000.

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[1] Andrew J. Bowden, Director, OCIE, "Spreading Sunshine in Private Equity," May 6, 2014, available at https://www.sec.gov/news/speech/2014--spch05062014ab.html.

[2] See, e.g., Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, "Conflicts, Conflicts Everywhere – Remarks to the IA Watch Annual IA Compliance Conference: the Full 360 View," February 26, 2015, available at https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html; Marc Wyatt, Director, OCIE, "Private Equity: A Look Back and a Glimpse Ahead," May 13, 2015, available at https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[3] *In the Matter of Kohlberg Kravis Roberts & Co., L.P.* (June 29, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4131.pdf.

2. In the Matter of Blackstone Management Partners, et al[4]

Three private equity fund advisers that are part of the Blackstone Group were charged with failing to disclose accelerated monitoring fees paid by Blackstone fund portfolio companies prior to the companies' sale or IPO and discounts on legal fees obtained by Blackstone but not completely passed along to the funds. The SEC alleged that the accelerated payments reduced the value of the portfolio companies before their sale, injuring the funds and fund investors. Blackstone charged a monitoring fee to each portfolio company held by its funds that was normally paid for a ten-year period. Before a sale or IPO, Blackstone terminated the monitoring agreements and accelerated payment of future monitoring fees. Although Blackstone disclosed the monitoring fees in private offering memoranda and limited partnership agreements, among other places, it did not disclose that such fees would be accelerated until after it collected such fees. Additionally, Blackstone failed to disclose a legal fee arrangement providing it with a much deeper discount on legal fees than the legal fees charged to its funds.

Notably, Blackstone undertook remedial efforts which included (i) voluntarily ending the disparate legal fee arrangement, (ii) disclosing to investors that the historical fee discounts had exceeded discounts provided to the Blackstone funds, and (iii) enhancing disclosures in offering documents to more accurately describe fee acceleration practices. Under the Order in this matter, Blackstone agreed to pay disgorgement and prejudgment interest of $28,911,756, and a civil money penalty of $10,000,000.

3. In the Matter of Fenway Partners, LLC, et al[5]

Fenway failed to disclose conflicts of interest to a fund client and investors when fund and portfolio company assets were used for payments to former firm employees and an affiliate. Fenway earned fees from management service agreements ("MSAs") with portfolio companies, which fees were partially offset against fund management fees charged to investors. In 2011, Fenway cancelled the MSAs and entered similar agreements with a consulting affiliate owned and operated in large part by Fenway principals. Fenway did not offset consulting fees under the 2011 agreements under which Fenway principals received compensation. The SEC found that (i) Fenway's disclosure to its Advisory Board about its fee practices was insufficient, (ii) Fenway omitted a material fact of a $1 million payment in a 2012 capital call to fund limited partners, and (iii) Fenway's financial statements were not GAAP compliant and did not disclose payments to the consulting affiliate. Penalties imposed included censure of Fenway and the individual principals of the consulting affiliate, total disgorgement and prejudgment interest of $8,716,471 and civil money penalties of $1,525,000.

4. In the Matter of Cherokee Investment Partners, LLC[6]

The general partner of certain Cherokee Funds charged those funds a total of $455,698 in fees for consulting, legal and compliance expenses that the general partner incurred in connection with preparing for registration as an investment adviser under the Investment Advisers Act of 1940

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[4] In the Matter of Blackstone Management Partners, LLC et al. (Oct. 7, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4219.pdf.

[5] *In the Matter of Fenway Partners, LLC, et al.* (Nov. 3, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4253.pdf.

[6] *In the Matter of Cherokee Investment Partners, LLC et al.* (Nov. 5, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4258.pdf.

(including formation of the funds' adviser), complying with legal obligations arising from registration (including preparing for examination by SEC staff), and responding to an SEC Division of Enforcement investigation. The formation and registration expenses for the adviser amounted to $171,000 and included fees for third party compliance consultants, counsel, and registration fees. Cherokee was examined by the SEC staff in 2013, and incurred consulting and legal fees and expenses of $239,362 which it charged back to the funds. In 2014, Cherokee charged $45,104 in expenses back to the funds paid by the general partner for legal fees in connection with the SEC's investigation into, among other things, expense allocation. While the relevant partnership agreements permitted the general partner to, in its good faith judgment, charge the funds for operational fees and expenses, those partnership agreements did not expressly permit charges for the advisers' own compliance and legal fees. In April 2015, prior to the issuance of the Order in this matter, Cherokee reimbursed the $455,698 to the affected funds. As a result of the findings in this matter, the SEC imposed civil money penalties of $100,000.

5. In the Matter of Cranshire Capital Advisors, LLC[7]

In the Cranshire Capital Advisors, LLC ("Cranshire") matter, the SEC found that Cranshire paid private fund legal, operating and compliance expenses in a manner that was not disclosed in the fund's governing documents. The SEC alleged a breach of fiduciary duty claim based on Cranshire's negligent charging of expenses and failure to adopt policies and procedures relating to allocation of fund expenses. In addition, the SEC identified a personal trading policy failure under which trades placed by the fund were not adequately monitored for conflicts of interest in violation of Cranshire's compliance policies. The SEC fined Cranshire $250,000

<u>What to Expect in 2016</u>

Private Equity Remains a Priority for SEC

It should come as no surprise that the private equity space will remain one of the SEC's top priorities in 2016.

In a May 2016 speech, Marc Wyatt spoke of the SEC's formation of the Private Funds Unit ("PFU"), which is dedicated to examining advisers to private funds, including private equity advisers.[8] Mr. Wyatt stated that many private equity advisers had made significant modifications to their Form ADV documents to add discussion of fee and expense practices, among other things, and noted that ADV disclosures alone would not necessarily completely cure prior disclosure shortcomings.[9] In addition to the expense and expense allocation issue, Mr. Wyatt identified co-investment allocation and private equity real estate advisers as additional areas where the PFU would be dedicating resources.

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[7] *In the Matter of Cranshire Capital Advisors, LLC* (Nov. 23, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4277.pdf.

[8] Marc Wyatt, Acting Director, OCIE, "Private Equity: A Look Back and a Glimpse Ahead," May 13, 2015, available at https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[9] Id.

The recently announced SEC Examination Priorities for 2016[10] include private equity advisers as one of the SEC's initiatives. While confirming a continued focus on private equity fees and expenses, OCIE identifies controls and disclosures associated with side-by-side management of performance-based and asset-based fee accounts as an area expected to receive examination resources. Moreover, in the event a private fund adviser has not yet been examined, the SEC will continue with its never-before-examined initiative.[11]

Conclusion

The SEC's interest and focus on private equity is on the rise as evidenced by the speeches and announcements mentioned above. Private equity advisers should consider taking the following steps in connection with their compliance programs:

- Perform a thorough assessment of fees and expense practices in order to understand what costs are borne by the funds, the general partners and fund investors;

- Ensure that the fees and expenses paid by private funds (and its investors) are fully described Form ADV Part 2A and each fund's governing documents;

- Ensure that the CCO and the adviser's compliance program has sufficient resources and is deeply integrated into the firm's business operations; retain counsel to evaluate fee practices, disclosures and regulatory compliance; and make enhancements changes wherever necessary.

For more information on this topic, please contact us at (619) 298-2880 or at info@jackolg.com.

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[10] The SEC 2016 Examination Priorities is available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

[11] See, e.g., OCIE's Letter to Never-Before Examined Investment Advisers, February 20, 2014, available at http://www.sec.gov/about/offices/ocie/nbe-final-letter-022014.pdf.