King & Spalding

Client Alert

Corporate Transactions and Real Estate Practice Group

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SEC Steps Up Scrutiny On Private Fund Fee Allocation Practices

In two recent cases, the Securities and Exchange Commission (the SEC) has made clear that it has increased its focus on private funds and their allocation of fees and expenses. In the most recent, the SEC entered an order on June 29, 2015 settling administrative proceedings against Kohlberg, Kravis Roberts & Co. L.P. ("KKR") that alleged improper fund expense allocation[1]. In April 2015, the SEC entered a similar order against Alpha Titans LLC ("Alpha Titans"), a hedge fund manager, making similar allegations of improper fund allocation practices.[2] The hedge fund manager, Alpha Titans, was found by the SEC to have improperly charged the private funds for manager-related operating expenses without authorization by and disclosure in the fund documents. The registered private equity fund manager, KKR, on the other hand, was accused of improperly allocating to certain private funds broken deal expenses that the SEC alleges should have been shouldered by co-investors. These two regulatory actions, and the recent speeches made by senior SEC leaders addressing concerns about fee allocation practices by private equity funds, highlight the need for hedge funds, private equity funds and real estate funds to take prophylactic measures to address expense allocation issues.

On June 29, 2015, without admitting or denying the SEC's findings, KKR agreed to pay close to $30 million (including a $10 million penalty) – a new high-water mark – to settle certain charges brought by the SEC in connection with improper allocation of broken-deal expenses in violation of its fiduciary duties. According to Andrew J. Ceresney, Director of the SEC Enforcement Division, "this is the first SEC case to charge a private equity adviser with misallocating broken deal expenses." According to the SEC, KKR allegedly misallocated more than $17 million in broken deal expenses[3] to its funds when those expenses should have been allocated to certain of its co-investors[4]. The SEC alleged that KKR's co-investors, including KKR management, benefited from the deal sourcing and, except for a partial allocation to certain co-investors in 2011, KKR did not allocate any portion of these broken deal expenses to co-investors for a period of six years ending in 2011. The SEC alleged that, instead of requiring the co-investors to pay their share of their cost of these expenses, KKR unfairly allocated all of the broken-deal expenses to the private funds it was advising.

According to the SEC, there was no language in the fund's operating agreements or offering materials providing that these expenses would not be

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allocated to the co-investors. Furthermore, the SEC alleged that KKR did not have a written compliance policy in place to govern its fund allocation practices until 2011, the end of the six-year period. In late 2011, KKR engaged a third-party consultant to review its fund expense allocation practices. The consultant's findings triggered the adoption of a new expense allocation methodology effective January 1, 2012, which involved attributing the broken deal expenses to co-investors based on factors such as the amount of committed capital, the amount of invested capital and the percentage of transactions available for co-investors to participate in light of the KKR funds' minimum investment rights. The new allocation methodology was not a subject of the Settlement Order.

These recent actions by the SEC are not surprising given that the SEC's Office of Compliance Inspections and Examinations ("OCIE") expressly declared that private equity fees and expenses would be a priority for its review in 2015.[5] This announcement, coupled with the recent spate of regulatory enforcement actions against private fund advisers such as Lincolnshire Management, Inc. and Clean Energy Capital, LLC,[6] for improper expense allocation practices signals the heightened focus of the SEC on expense allocation. In Andrew Bowden's now famous "sunshine speech,[7]" Mr. Bowden highlighted the fact that, when OCIE has examined how fees and expenses are handled by advisers to private equity funds, it has identified violations of law or material weaknesses in controls over 50% of the time.

On April 29, 2015, the SEC filed a settled order in proceedings against Alpha Titans (an investment adviser registered with the SEC that advises hedge funds) alleging improper allocation of fund assets to pay undisclosed manager-related operating expenses. These expenses included Alpha Titans' employee salaries and health benefits, rent, parking, utilities, computer equipment, technology services, and other operational costs. The SEC found that, over a period of four years, Alpha Titans was using fund client assets to pay these manager-related operational expenses in violation of its fiduciary duties.

The SEC alleged that none of the operating agreements and offering memoranda relating to the funds advised by Alpha Titans contained disclosures describing that the funds would be footing the bill for these operating expenses[8]. Furthermore, according to the order - as a corollary to the improper expense allocation - the audited financial statements that were sent to investors did not contain a clear description of the total amount of expenses paid by the funds and the related party relationships[9]. The order further found that, in addition to the misleading financial statements, Alpha Titans also omitted information about how these operating expenses constituted compensation to the adviser in Alpha Titans' Form ADV. Moreover, as is the case with many of these types of violations of the adviser's fiduciary duties, the SEC alleged that Alpha Titans' Compliance Manual did not include specific information about related party transactions and disclosures that should have described how Alpha Titans would act in the best interest of its fund clients vis-à-vis related party transactions.

To settle the charges, Alpha Titans and its principal, Mr. Timothy McCormack, agreed to pay approximately $700,000 in disgorgement and interest, including a penalty of $200,000. The firm's outside auditor agreed to pay a penalty of $75,000 for approving misleading financial statements. In addition, Mr. McCormack and Alpha Titans' general counsel[10] agreed to be barred from the securities industry for one year, with the general counsel consenting to a one-year suspension from practicing as an attorney on behalf of any SEC-regulated entity. The auditor, likewise, agreed to a suspension from practicing as an accountant for any SEC-regulated entity for at least 3 years.

True to its word, the SEC is stepping up its focus on whether private fund advisers allocate their fees and expenses fairly and with adequate disclosure. Previously, in a speech to the New York City Bar Association on May 11, 2012[11], Norm Champ, the former Deputy Director of OCIE pointed out that a firm's disclosure policies and procedures should address the allocation of its fees and expenses and that a firm should clearly disclose to clients the fees that it is earning in connection with managing investments as well as expense allocations between a firm and its client funds.

We expect that in the future, the SEC will continue to sharpen its focus on how expenses are allocated among the private funds and the investment manager as well as among co-investors and private funds. These recent actions should serve as timely reminders for private fund managers to review and revise their compliance policies and procedures to ensure that a fair and appropriate expense allocation methodology is described therein. Private fund managers should also review disclosures contained in fund operating documents; disclosure documents (such as PPMs) and Form ADVs to ensure that these documents contain accurate, consistent and precise language relating to expense allocation. Finally, it would be prudent for fund managers to ensure that records - documenting how expense allocations are made and the rationale therefor - are maintained to evidence the fact that the fund manager has addressed allocations and conflicts of interest in a reasonable and justifiable manner.

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[1] *In the Matter of Kohlberg Kravis Roberts & Co. L.P.,* SEC Release No. IA- 4131 (June 29, 2015).

[2] *In the Matter of Alpha Titans, LLC, Timothy P. McCormack, and Kelly D. Kaeser, Esq*., SEC Release No. IA-4073 (April 29, 2015).

[3] Broken deal expenses include those expenses related to deal sourcing and deal due diligence (e.g., payments to lawyers and other professionals, research costs and travel costs) for investments that are not ultimately consummated.

[4] KKR sought capital from certain co-investors (including KKR management) who provided additional capital for certain deals that were outside of the Fund's mandate, because either the deals required capital that exceeded the specified investment level appropriate for the Fund and/or for diversification purposes.

[5] See OCIE "Examination Priorities for 2015" National Examination Program, Office of Compliance Inspections and Examinations (January 13, 2015).

[6] *In re Lincolnshire Management Inc*., SEC Release No. IA-3927 (Sept. 22, 2014) and *In re Clean Energy Capital LLC et al*., SEC Release No. 33-9667 (Oct. 17, 2014).

[7] "*Spreading Sunshine in Private Equity*" by Andrew J. Bowden, Director OCIE at Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014)

[8] The operating memoranda and operating agreements contained broad language providing that the relevant Fund advised by Alpha Titans would bear all the costs and expenses of the Fund's operation. Neither the operating Agreements nor the PPMs contained any language stating that the Funds would bear the cost of any manager-related operational or administrative expenses.

[9] Given that the financial statements did not contain information about certain related party relationships, they were deemed not to be prepared in accordance with GAAP in violation of the custody rule.

[10] It was alleged that the General Counsel aided and abetted and caused the violations by, among other things, (i) approving the offering memoranda which did not include adequate disclosures about the fee allocation; (ii) reviewing the misleading financial statements and signing certain management representation letters addressed to the auditor, which included a representation that inaccurately stated that related party relationships and transactions had been properly recorded and disclosed in the financial statements and (iii) reviewing and updating Alpha Titan's Compliance Manual which did not include policies and procedures addressing the control of related party transactions.

[11] "*What SEC Registration Means For Hedge Fund Advisers*" by Norm Champ, the former Director of the OCIE at the New York City Bar Association (May 11, 2012).