King & Spalding

Client Alert

Special Matters & Government Investigations Practice Group
Private Equity & Investment Funds Practice Group

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SEC Enforcement Against Private Equity Firms
A Focus on Disclosure, Fees, and Conflicts of Interest

The Securities and Exchange Commission announced two settled enforcement actions against private equity fund advisers last week involving certain fee practices and potential conflicts of interest. Consistent with its approach in other enforcement actions against private equity firms, the SEC did not brand the fee practices and potential conflicts themselves as fraudulent. Instead, the SEC's orders framed the violations as disclosure failures.

These two recent actions are consistent with the SEC's approach to enforcement in the private equity industry. SEC Director of Enforcement Andrew Ceresney has repeatedly stressed the Division's focus on disclosure, and has said he believes this emphasis is achieving the intended result by encouraging industry discussions around whether certain fees and arrangements are appropriate. Indeed, in the press release announcing one of last week's settlements, Ceresney stated that, "A common theme in our recent enforcement actions against private equity firms is their failure to properly disclose fees and conflicts of interest to fund investors."

It is clear that the SEC has gravitated toward challenging particular fee practices and potential conflicts of interest. Private equity firms should therefore take note of the practices described in these cases. They provide a roadmap of issues that the SEC believes should either be disclosed or possibly eliminated.

Monitoring Fees and Creative Loan Arrangements

The two settled enforcement actions announced last week echo facts from prior actions, and they underscore the SEC's main target areas for enforcement investigations in the private equity fund industry.

The first action was a settled administrative proceeding announced on August 23 against four advisers affiliated with Apollo Global Management.[1] In the order instituting the administrative proceedings, the SEC did not allege that the fees and conflicts at issue were themselves fraudulent or manipulative. Instead, the SEC alleged that the Apollo advisers failed to adequately disclose the practices, which left the investors "unable to gauge the impact on their investments." In this case, the SEC stated that the Apollo advisers had entered into monitoring agreements with

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portfolio companies owned by Apollo-advised funds, allowing the Apollo advisers to charge fees for providing certain consulting and advisory services to the portfolio companies. When those portfolio companies were sold or taken public, the Apollo advisers would terminate the monitoring agreements and accelerate the payment of future monitoring fees. The SEC argued that this practice of accelerating the future fees should have been disclosed to the funds' limited partners prior to their commitment of capital. The SEC previously took issue with a similar fee-acceleration practice in a settled enforcement action against several Blackstone Capital adviser firms last October.[2]

The SEC also took issue with the lack of disclosure relating to a loan arrangement that one of the Apollo advisers implemented to defer taxes that its limited partners would owe on carried interest from the fund. The loan arrangement required the Apollo adviser to pay interest on the loan arrangement, but that interest ultimately was allocated solely to the Apollo adviser's own capital account. The SEC alleged that failing to disclose that the interest was ultimately accrued to the Apollo adviser's account made the financial statements around that loan arrangement materially misleading.

The SEC's order found that the Apollo advisers violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940, along with related Rules 206(4)-7 and 206(4)-8, none of which require a showing of *scienter*.[3] Without admitting or denying the findings, the Apollo advisers agreed to pay more than $37.5 million in disgorgement and $2.7 million in interest to affected fund investors, along with a $12.5 million civil penalty to the government.

The SEC's order cited the Apollo advisers' cooperation during the investigation, as well as certain remedial actions taken prior to the settlement. In unusually effusive language, the order stated, in part, that "Apollo was extremely prompt and responsive in addressing staff inquiries." The order also specifically stated that the Commission was not imposing a more significant penalty based upon the Apollo advisers' cooperation in the investigation.

Allocating Fees and the Benefits of Cooperating

The SEC also instituted a settled administrative proceeding on August 24 against Invesco-owned WL Ross & Co. LLC.[4] The SEC's order found that, from 2001 to 2011, WL Ross had a practice of allocating certain transaction fees among the funds it advised, based on deal events, closings, financial advice, and investment banking transactions, among other things. When the WL Ross funds paid those transaction fees, the governing limited partnership agreements credited the funds toward the regular management fees owed to WL Ross, which meant that the funds allocated higher transaction fees would have to pay WL Ross less in the form of management fees. According to the SEC's order, however, there were multiple instances where WL Ross incurred transaction fees from portfolio companies in which more than one of its funds was invested. The SEC's order found that WL Ross decided—but did not disclose to investors—that it would allocate the fees based on the funds' relative investment shares in the given portfolio company. In the SEC's view, that created a problem where there were co-investors in a portfolio company alongside the WL Ross funds. According to the SEC order, "WL Ross retained for itself that portion of the Transaction Fees that was based upon co-investors' relative ownership of the portfolio company, without subjecting such fees to any management fee offsets."

The SEC calculated that this allocation method resulted in WL Ross making approximately $10.4 million more in management fees from the funds than it would have by simply allocating the transaction fees *pro rata* among the funds. The SEC found that WL Ross' failure to disclose how it was allocating the transaction fees violated Sections 206(2) and 206(4) of the Advisers Act, along with related Rule 206(4)-8, none of which require a showing of *scienter*. Without admitting or denying the SEC's findings, WL Ross agreed to pay a $2.3 million penalty to settle the proceedings.

Notably, however, WL Ross was not required to pay disgorgement as part of the settlement, and the $2.3 million penalty was less than a quarter of the calculated harm to investors. Although, unlike the *Apollo* order, the *WL Ross* order did not specifically state that the penalty amount was reduced due to WL Ross's cooperation, the order did describe several steps that the firm took which likely led to the reduced penalty amount. First, WL Ross identified the fee allocation issue while reviewing certain fee data it had produced to SEC examiners, then self-reported the issue to the SEC staff during an exam being conducted by the Office of Compliance Inspections and Examinations ("OCIE"). WL Ross then voluntarily proposed and adopted a new methodology for allocating the transaction fees *pro rata*, and voluntarily reimbursed the funds approximately $10.4 million in management fees and $1.4 million in interest—effectively a self-initiated disgorgement—during the course of the SEC exam and resulting enforcement investigation.[5]

A Disclosure-Focused Enforcement Approach

The SEC only recently gained the level of authority it now has to regulate private equity firms. Starting in 2012, a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act required advisers to private equity funds with more than $150 million in assets to begin registering with the SEC as investment advisers.[6] That registration requirement subjected many private equity fund advisers to SEC examinations for the first time, providing the SEC with the opportunity for a clearer view into industry practices and the inner workings of registered firms.

Following the wave of registrations in 2012, the SEC's OCIE launched a Presence Exam initiative to conduct examinations of private equity firms.[7] The initiative was a way for the SEC to identify and assess industry practices, some of which had been long-standing but had not previously received the level of scrutiny that comes with an SEC examination. In May 2014, while OCIE was in the middle of that initial round of examinations, Andrew J. Bowden, then the director of OCIE, highlighted fees, expenses, and potential conflicts of interest as some of the issues OCIE examiners were encountering.[8]

Several investigations—and ultimately enforcement actions—spun out of those OCIE examinations, led by the Enforcement Division's Asset Management Unit. The AMU is a relatively new creation, as well, having been established as part of a reorganization of the Enforcement Division during the summer of 2010. In a February 2015 speech, Julie Riewe, then co-chief of the AMU, told a gathering of industry participants that the AMU was working "very closely with the exam staff" and expected to see "more undisclosed and misallocated fee and expense cases."[9] Riewe also highlighted the AMU's focus on conflicts of interest.

The SEC's Enforcement Division has been transparent about its preference for bringing cases about fees, expenses, and potential conflicts of interest in the private equity industry as disclosure cases, rather than taking a stance on what practices should be eliminated from the industry. In a speech this spring at the Securities Enforcement Forum West in San Francisco, California, Enforcement Director Andrew Ceresney explained that the SEC is able to make its intended impact on the industry with this approach.[10] "[T]he increased transparency has fostered a healthy dialogue between investors and advisers on what sorts of fees are appropriate and who should receive the benefits of those fees," Ceresney said. "I have been asked before whether we will bring a case asserting that a particular type of fee constitutes a breach of fiduciary duty. Whether we will or not, it is my belief that awareness and transparency of fees generally will lead investors and advisers to reach an appropriate balance in terms of types and allocation of fees."

In his speech, Ceresney cited separate fee-transparency initiatives from an industry organization and from a group of comptrollers and treasurers as evidence of this "healthy dialogue." A recently passed California bill is another sign that the SEC's disclosure-focused cases are inspiring investors to take a closer look at private equity fees.[11]

The bill, which now awaits Gov. Jerry Brown's approval, would require public pension funds in California—including some of the largest in the country—to report certain details about the fees and carried interest they pay to private equity and hedge funds.

Takeaways

Based on recent press reports, it appears the SEC remains focused on investigating fee practices in the private equity industry, along with the potential conflicts that can arise from those fees.[12] This Alert's quick look at two recent enforcement actions suggests several lessons to help private equity firms navigate an SEC examination or investigation or, even better, to avoid drawing scrutiny in the first place:

- While the SEC has not yet branded certain fees and conflicts as fraudulent or manipulative in and of themselves, it is worth monitoring the types of practices that underlie the disclosure cases brought against private equity firms. If your private equity firm is engaging in practices similar to those flagged in recent SEC cases, then it is time to consider revisiting these practices and/or your related disclosures about them.

- When drafting fund formation documents, pay particular attention to any fees or practices that result in actual, or even potential, benefits to the advisers or to the general partners. If the benefit creates a potential conflict with the interests of limited partner investors or the investment funds, then you should consider how to manage or eliminate that conflict and review the adequacy of your disclosures about those fees or practices. This is true even if you believe the fee or potential conflict is well-known in the industry.

- Consult with counsel for a view on whether or not a new or revised disclosure is warranted. Proactively seeking expert advice about an issue will demonstrate to the SEC staff that you made an effort to do the right thing, even if the staff ultimately disagrees with your conclusion. In the event that an enforcement action is unavoidable, such steps may make the difference between reaching a settlement based on non-*scienter* violations, versus an action alleging intentional or reckless misconduct.

- Working proactively with the SEC's Enforcement Staff to cooperate with their investigation can also pay dividends. Private equity firms that become involved in an SEC Enforcement investigation (or even a contentious OCIE exam) that has surfaced issues on fees or expenses should promptly consider what type of remediation is appropriate, including possibly supplementing their disclosures mid-investigation. As the *Apollo* and *WL Ross* matters show, SEC Staff is willing to give substantial credit to private equity respondents that self-report potential issues and cooperate with an investigation. Similarly, as these matters show, the staff also is likely to credit remedial steps taken by a firm to address issues and improve practices going forward.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

[1] *In the Matter of Apollo Mgmt. V, L.P. et al.*, Admin. Proc. File No. 3-17409 (Aug. 23, 2016), https://www.sec.gov/litigation/admin/2016/ia-4493.pdf.

[2] *In the Matter of Blackstone Mgmt. Partners, L.L.C., et al.*, Admin. Proc. File No. 3-16887 (Oct. 7, 2015), https://www.sec.gov/litigation/admin/2015/ia-4219.pdf.

[3] The order also found that Apollo failed reasonably to supervise, pursuant to Section 203(e)(6) of the Advisers Act, a partner who charged personal expenses to certain Apollo funds.

[4] *In the Matter of WL Ross & Co. LLC*, Admin. Proc. File No. 3-17491 (Aug. 24, 2016), https://www.sec.gov/litigation/admin/2016/ia-4494.pdf.

[5] During its time under scrutiny from the SEC's OCIE examiners and Enforcement investigators, WL Ross also hired a new Chief Compliance Officer and engaged an independent accounting firm to perform an internal controls review of its back-office. While describing WL Ross' remediation efforts, the SEC fittingly noted that "WL Ross also disclosed the new methodology and reimbursement to the WLR Funds' investors in a series of written communications and meetings."

[6] *Dodd-Frank Act Changes to Investment Adviser Registration Requirements*, SEC Division of Investment Management, https://www.sec.gov/divisions/investment/imissues/df-iaregistration.pdf.

[7] *Private Equity: A Look Back and a Glimpse Ahead*, speech by Marc Wyatt, Acting Director, SEC Office of Compliance Inspections and Examinations, May 13, 2015, https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[8] *Spreading Sunshine in Private Equity*, speech by Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, May 6, 2014, https://www.sec.gov/news/speech/2014--spch05062014ab.html ("A private equity adviser typically uses client funds to obtain a controlling interest in a non-publicly traded company. With this control and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend.").

[9] *Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View*, speech by Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, Feb. 26, 2015, https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

[10] *Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement*, speech by Andrew Ceresney, Director, SEC Division of Enforcement, May 12, 2016, https://www.sec.gov/news/speech/private-equity-enforcement.html.

[11] Dawn Lim, *California Fee-Transparency Bill Awaits Governor's Signature*, WALL ST. J. (Aug. 26, 2016), http://www.wsj.com/articles/california-fee-transparency-bill-awaits-governors-signature-1472254830.

[12] *See, e.g.,* Aruna Viswanatha, *Private-Equity Firms Move Into SEC Crosshairs*, WALL ST. J. (Aug. 19, 2016), http://www.wsj.com/articles/private-equity-firms-move-into-sec-crosshairs-1471646498.