Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: CSC

Fund Advisers and Fee Disclosure in SEC Enforcement Action

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October 7, 2015, the US Securities and Exchange Commission (the Commission or SEC) entered into a settlement agreement with Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C. (collectively, Blackstone) regarding certain Blackstone fee and expense disclosure practices. Without admitting or denying the Commission's findings, Blackstone consented to a cease-and-desist order and agreed to pay nearly $40 million to settle the charges consisting of $26,225,203 of disgorgement, $2,686,553 of prejudgment interest, and $10,000,000 of civil money penalties. This action represents a continuing focus by the SEC on fee and expense allocation and disclosure practices of private fund advisers.[1] It serves as a reminder of the need for advisers to private investment funds to review and revise as necessary their compliance and disclosure policies and procedures related to the allocation of fees and expenses.

Blackstone's Fee Allocation Practices and SEC Settlement

The SEC brought two distinct breach of fiduciary duty charges against Blackstone: one for Blackstone's purported practice of accelerating monitoring fees charged to portfolio companies upon certain trigger events and the other for allegedly negotiating and accepting disparate legal fee discounts whereby Blackstone received greater legal fee discounts than did the Blackstone-advised funds.

Acceleration of Monitoring Fees

According to SEC documents, Blackstone-advised funds typically own multiple portfolio companies. Blackstone typically enters into monitoring agreements with each portfolio company pursuant to which Blackstone provides each portfolio company certain consulting and advisory services for an annual fee. The fee is paid by each fund-owned portfolio company. Aside from a certain amount of offset, these monitoring fees are in addition to the annual management fee paid to Blackstone by each funds' respective limited partners. The fee arrangements are set forth in each limited partnership agreement or investment advisory agreement.

[1] Both the SEC's Division of Enforcement (through its Asset Management Unit) and Office of Compliance, Inspections and Examinations (OCIE) continue to make improper expense allocation and undisclosed fees a high priority in their respective programs. For further discussion, please see our prior post, Scrutiny of Private Equity Firms.

Prior to 2013, the monitoring agreements commonly included 10-year terms, some of which included evergreen provisions that automatically extended the life of the agreement for an additional term. According to the SEC, from at least 2010 through March 2015, upon certain trigger events, such as the private sale of a portfolio company or an initial public offering (IPO), Blackstone terminated certain portfolio company monitoring agreements and accelerated the payment of future monitoring fees. While Blackstone disclosed to prospective limited partners of its advised funds that Blackstone may receive monitoring fees, Blackstone purportedly only disclosed that it may accelerate future monitoring fees upon termination of the monitoring agreements after the limited partners had made their capital commitments. Specifically, the disclosures concerning acceleration of future monitoring fees upon termination of the monitoring agreements were made in distribution notices, quarterly management fee reports, and, in the case of IPOs, Form S-1 filings. By the time these disclosures were made, the limited partners had already committed capital to Blackstone-advised funds, the accelerated fees had already been paid, and the limited partnership advisory committee of each fund could not object to or dispute the acceleration of monitoring fees.[2] Despite the partial offset of these fees against the annual management fee, the net effect of the accelerated payments was to reduce the value of the funds' assets (i.e., the portfolio companies making the accelerated monitoring payments) when sold or taken public, which in turn reduced the proceeds available for distribution to limited partners.

The SEC noted that because Blackstone had a conflict of interest as the recipient of the accelerated monitoring fees it could not effectively consent to the fee acceleration practice on behalf of the funds. As such, the SEC charged Blackstone with breaching its fiduciary duty to its funds in violation of Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act) and violating Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

Disparate Legal Fee Discounts

According to SEC documents, in late 2007, Blackstone negotiated a single legal services arrangement with its primary outside law firm on behalf of both itself and certain of its advised funds whereby Blackstone received a discount from the law firm that was substantially greater than the discount received by the funds. This arrangement continued from at least late 2007 through early 2011; however, Blackstone did not disclose the disparate legal fee discounts to the funds, the funds' respective limited partnership advisory committees, or the funds' limited partners. After an early-2011 internal Blackstone audit, Blackstone voluntarily ended the disparate legal fee arrangement with the law firm and adopted a new task-based legal services arrangement pursuant to which Blackstone and the funds received the same discounts. In August 2012, Blackstone disclosed to all of its funds' limited partners the disparate legal fee discounts that had been in place from late 2007 through early 2011. As with the acceleration of monitoring fees, the SEC noted that because of its conflict of interest as the beneficiary of the disparate legal fee discounts, Blackstone could not effectively consent to the undisclosed practice on behalf of the funds.

[2] As is common in the private equity industry, each fund's limited partnership agreement provided for the establishment of a limited partnership advisory committee, among other things, to review and approve or disapprove potential conflicts of interest in any transaction or relationship, including those relating to the receipt of certain fees. It is unclear whether Blackstone had submitted the evergreen and acceleration provisions to the advisory committees for approval.

Based on these practices, the SEC charged Blackstone with breaching its fiduciary duty to its funds in violation of Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

Lack of Written Policies and Procedures

Pursuant to the Advisers Act rules, registered investment advisers must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. The SEC noted that Blackstone "did not adopt or implement any written policies or procedures reasonably designed to prevent violations of the Advisers Act or its rules arising from the undisclosed receipt of fees or conflicts of interest" (presumably specifically with respect to the practice of receiving accelerated monitoring fees and receiving a more favorable legal fee discount than its advised funds) and, as such, charged Blackstone with violating Section 206(4) of the Advisers Action and Rule 206(4)-7 thereunder.[3]

Cooperation and Remedial Efforts

The SEC emphasized in its settlement that it considered remedial acts taken by Blackstone prior to contact from SEC staff and cooperation afforded the SEC staff after Blackstone was contacted in determining to settle the charges. Specifically, the settlement order noted the following:

- In early 2011, Blackstone voluntarily ended its disparate legal fee arrangement with its law firm and, in 2012, Blackstone disclosed to all limited partners, without any resulting complaints, that historical discounts offered to Blackstone exceeded discounts provided to the funds.
- For all funds formed after 2012, Blackstone has disclosed in the private placement memoranda that monitoring agreements may contain acceleration provisions that trigger lump sum payments. Since 2012, Blackstone has not entered into any such provisions and since 2010, Blackstone has not taken advantage of any evergreen provisions in existing agreements when collecting a lump sum payment.
- In 2012, Blackstone enhanced the disclosures it makes after taking accelerated monitoring payments by explicitly identifying termination payments in reports distributed to limited partners and setting forth in detail the assumptions underlying the valuation of such payments.
- In 2014, prior to the SEC investigation, Blackstone changed its business practices and further disclosed that it will not accelerate monitoring fee payments when it completely exits a portfolio company through private sale and will not accelerate more than three years (equal to the approximate average post-IPO length of time before Blackstone has made full exits) of remaining monitoring fee payments in the event of an IPO.

[3] Section 206(2), which is based on a negligence standard that does not require proof of scienter, prohibits investment advisers from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 206(4) and Rule 206(4)-8 thereunder make it unlawful for any investment adviser to a pooled investment vehicle to "[m]ake any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or "engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

- Throughout the staff's investigation, Blackstone voluntarily and promptly provided documents and information to the staff. Blackstone met with the staff on multiple occasions and provided detailed factual summaries of relevant information. Blackstone was extremely prompt and responsive in addressing staff inquiries.

The settlement order further noted that the SEC is not imposing a civil penalty in excess of $10 million based upon Blackstone's cooperation in the SEC investigation and related enforcement action. The SEC emphasized cooperation and remedial action in this order with greater force than in other recent actions, although it is not uncommon for the SEC to reward firms for being proactive in addressing an issue once it has arisen, and for working cooperatively with SEC staff.[4]

Conclusion

The SEC's most recent fee and expense allocation and disclosure action taken against Blackstone is in keeping with prior fee actions and represents the SEC's continuing strong focus on this category of cases. In particular, this action represents the SEC's concern not only with the amount of disclosure—of which there was a fair amount in this case—but also the timing of disclosure relative to when capital commitments of investors were made. Therefore, for many reasons, it would be prudent for private equity firms and other advisers to private investment funds to re-evaluate their fee and expense allocation policies and procedures to confirm that they adhere to current regulatory and investor expectations, particularly with respect to the timing of disclosure. While the highest priority should be compliance with applicable law, a review of the Blackstone order indicates that private equity firms who are not in full compliance with the Advisers Act will likely benefit from reduced penalties by taking good faith remediation efforts. The settlement also is relevant to advisers to real estate and hedge fund complexes that face similar fee and expense allocation issues. Advisers to all types of private funds should ensure that their fund offering documents thoroughly state how funds will be allocated, prepare, and follow fee and expense allocation policies and take steps to mitigate any past compliance failures.

[4] Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder require registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.