



Private Equity Management of Fees and Expenses: A Cautionary Tale

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Tuesday June 3, 2014

Editor's Note: The following post comes to us from [Veronica E. Rendón](#), partner at Arnold & Porter LLP and co-chair of the firm's Securities Enforcement and Litigation practice. This post is based on an Arnold & Porter memorandum.

In recent weeks, the Securities and Exchange Commission (SEC) has revealed that it is closely reviewing how private equity fund advisers disclose the allocation of fees and expenses to their investors. The SEC is primarily implementing this review through the Presence Exam Initiative (the Initiative), which has been initiated through the SEC's Office of Compliance Inspections and Examinations (OCIE).¹ Under the Initiative, the SEC has examined more than 150 newly-registered private equity advisers. According to the OCIE, the goal is to examine 25% of the new private fund registrants by the end of the year. The SEC has indicated that over 50% of the newly-registered private equity fund advisers that it has examined to date have either violated the law or have demonstrated material weaknesses in their controls related to the allocation of fees and expenses. The SEC has identified inadequate policies and procedures and inadequate disclosure as related issues, with deficiencies in these arenas running between 40% and 60% of all adviser examinations conducted, depending on the year. This sheer number of perceived deficiencies likely will result in increased regulatory investigations, enforcement activity and possible sanctions, as well as increased exposure to investor-initiated lawsuits. As a result, (i) sophisticated fund investors will likely start asking questions to determine whether their fund managers engage in these practices and (ii) private equity firms should consider compliance and disclosure practices that can help limit this exposure.

Recent SEC Remarks on Undisclosed Fees and Expenses

¹ "Spreading Sunshine in Private Equity," remarks of Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Private Equity International (PEI), Private Fund Compliance Forum 2014, (New York, NY, May 6, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361#> (hereinafter, Bowden Remarks).

On April 29, 2014, in testimony before a U.S. House of Representatives panel, SEC Chair Mary Jo White noted that SEC examiners have uncovered numerous problems with how private equity fund managers are allocating and disclosing fees and expenses. Then, on May 6, 2014, Andrew Bowden, Director of the OCIE, stated that the OCIE has found widespread instances of insufficiently disclosed fees in the private equity industry.² In particular, he pointed to:

- **Payments to Consultants**—Consultants, also known as “operating partners,” are individuals whom fund managers engage to provide assistance to portfolio companies. Operating partners often appear to investors to be employees of the fund manager. However, unlike actual employees of the fund manager (the expense of which is generally borne by the fund manager), they are either paid directly by the portfolio companies they advise or their compensation is expensed to the fund, and such payments do not reduce the management fee paid by the fund to the fund manager. According to Director Bowden, this arrangement is often not sufficiently disclosed to investors.
- **Shifting Expenses During the Fund’s Life**—Director Bowden also noted that there appears to be a trend of private equity fund managers shifting expenses from the manager to the fund in the middle of the fund’s life, without disclosure to the investors. In certain cases, a fund manager will hire an individual as its employee during the fundraising phase, only later to terminate and rehire the individual as a “consultant” or an “operating partner,” whose fees are paid by the fund or the portfolio company rather than the fund manager.
- **Characterization of Expenses**—In some cases, private equity fund managers are billing their funds for various functions that managers have traditionally performed in exchange for the management fee, including certain regulatory compliance, legal, accounting and investor reporting functions. Director Bowden stated that some managers are changing the characterization of such expenses from manager expenses to fund expenses without proper disclosure to investors.
- **Hidden Fees**—Director Bowden also asserted that some fees are simply not disclosed to private equity investors, including: fees for terminating the monitoring agreement between a fund manager and a portfolio company upon a merger or acquisition or IPO; “administrative” or other transaction fees not contemplated by the limited partnership agreement, such as fees paid upon recapitalizations; and fees charged by related-party service providers.

² *Id.*

Director Bowden focused on limited partnership agreements as important sources of disclosure that, despite the typically heavy negotiation of their terms between private equity fund managers and investors, often lack sufficient detail regarding such fees and expenses in the view of SEC examination staff.

Related Enforcement Activity

In a recent civil enforcement action, the SEC alleged a particularly egregious example of the misuse of hidden fees.³ In this action, which the SEC instituted against an entity called Clean Energy Capital, LLC (CEC), the SEC contends that CEC and its main portfolio manager, Scott Brittenham, improperly allocated more than US\$3 million of CEC's expenses to the funds CEC manages. The SEC contends that CEC and Mr. Brittenham made these allocations without adequate disclosure to investors, and therefore wrongfully misappropriated assets from the CEC funds. The largest of the alleged improper expenses includes the salaries of the majority of CEC employees, executive bonuses, health benefits, retirement benefits and rent. The SEC also alleges that CEC and Mr. Brittenham secretly caused the funds to borrow money to pay the expenses from CEC at unfavorable rates, pledging the funds' own assets as collateral. While CEC refutes the SEC's charges, and may ultimately prevail in the action, the enforcement action should serve as a cautionary tale to private equity firms that have potentially failed to adequately disclose fees and allocations.

Compliance and Disclosure Requirements

Although the allegations relating to the CEC case are extreme in nature, any undisclosed fees or expense allocations may be deemed to run afoul of the securities laws, particularly in the context of an SEC regime that is strongly enforcement-oriented. Undisclosed fees and expense allocations put private equity fund managers at risk of both regulatory action and investor lawsuits based on claims of purported fraud, misrepresentation, breach of fiduciary duty and breach of limited partnership agreements. Strong compliance programs and disclosure are paramount in preventing these issues from arising or, if occurring, from becoming increasingly problematic. The golden rule of securities disclosure is that if there is a substantial likelihood that the disclosure of an omitted fact would be viewed by a reasonable investor as important to its investment decision, then the fact is material and disclosure is required. Depending on the circumstances, one can imagine the SEC and investors claiming—fairly or unfairly—that any allocation of fees and expenses to the fund or its portfolio companies that is not fully disclosed is material.

³ *In The Matter of Clean Energy Capital, LLC and Scott A. Brittenham, Respondents*, SEC Rel. No. 9551, 2014 WL 709469 (Feb. 25, 2014).

Fund managers should review their fee and expense practices against disclosures made to investors to identify any gaps between disclosure and actual practice that may need to be addressed. Fund managers who believe that their firm may be at risk of drawing an SEC investigation based on undisclosed fees or expenses should consult with internal or outside counsel, identify the scope of the issue, and consider the impact of the issue on the fund and its investors. If appropriate and warranted, fund managers may consider self-disclosing the issue to investors and regulators, in connection with taking appropriate remedial steps. Even if certain practices are considered to be common within the industry, the SEC is sending a message regarding how it views such practices. This is likely welcome news to fund investors, and a wake-up call for many fund managers.