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INVESTMENT ADVISERS

Private Equity Management of Fees and Expenses: A Cautionary Tale





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The Securities and Exchange Commission (SEC) is closely reviewing how private equity fund advisers disclose the allocation of fees and expenses to their investors. 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's concern about this matter may in some cases be greater than that of investors. This is because, for the most part, the fees and expenses at issue are often very small in proportion to the size of the funds to which they are being allocated, and amount to little more than rounding errors in computing overall returns. In fact, some investors may be more concerned about the expense load of the compliance burden imposed on their managers by the SEC's scrutiny than on any fee or expense allocations, so long as those allocations are not otherwise egregious or fraudulent.

Nonetheless, especially because the SEC has started a dialogue about private equity fees and expenses, it is in the best interest of both fund managers and investors to ensure that the expectations are clear with regard to fees and expenses before the investor puts money in a fund. As a result, (i) fund investors should ask questions to determine whether their fund managers have adequate disclosure practices related to the allocation of fees and expenses; and (ii) private equity firms should engage in transparent dialogue with investors and consider compliance and disclosure practices that can help limit their exposure to regulatory enforcement.

SEC Presence Examinations

Until the Dodd-Frank Act of 2010, private equity fund managers were generally not required to register with the SEC. Dodd-Frank required private equity managers with at least $150 million in assets to register with the SEC and submit themselves to SEC examinations. In its examinations of newly-registered private equity fund managers, 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.

The SEC has uncovered these deficiencies by requiring detailed information about fees and expenses charged to funds and portfolio companies in their examinations of fund manager. This information goes beyond the disclosure that many fund managers typically provide to investors and can include the actual numbers on:

- Fees earned by the fund manager from each portfolio company and whether such fees were credited to the fund;

■ All compensation of all types (beyond just the management fee and performance fees) received by the fund manager and its affiliates; and

■ Total expenses reimbursed by each portfolio company.

Recent SEC Remarks on Undisclosed Fees and Expenses

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 as a result of fund manager examinations.[1] 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 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 to later 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.

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.

Enforcement Activity

In a recent civil enforcement action, the SEC alleged a particularly egregious example of the misuse of hidden fees.[2] 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 at unfavorable rates to pay CEC's expenses, 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 failed adequately to disclose fees and allocations.

KKR Capstone

In the past there was not extensive media discussion of private equity fee and expense allocations, partially because private equity documentation is confidential and partially because those allocations are generally not transparent even to fund investors. Director Snowden's remarks may have started a more open dialogue on this subject. For example, on May 21, 2014 *The Wall Street Journal* reported on the legal relationship between private equity giant KKR & Co. (KKR) and its related entity Capstone.[3] After obtaining key portions of a 2006 KKR limited partnership agreement, *The Wall Street Journal* took the position that KKR may be violating the terms of that agreement by not sharing consulting fees earned by Capstone with the 2006 fund. KKR has taken the legal position that Capstone is not an ''affiliate'' and therefore KKR is not required to share Capstone's consulting fees with the 2006 fund as required under the agreement. *The Wall Street Journal* story shows that the door has been opened to a public discussion of a subject that was once relatively opaque.

Fund Managers: Compliance and Disclosure Programs

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 fee 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

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[1] Andrew J. Bowden, Dir., Sec. & Exch. Comm'n Office of Compliance Inspections & Examinations, Speech at Private Equity International Private Fund Compliance Forum 2014: Spreading Sunshine in Private Equity (May 6, 2014).

[2] *In re Clean Energy Capital, LLC*, SEC Rel. No. 9551, 2014 WL 709469 (Feb. 25, 2014).

[3] *Wall Street Journal*, May 21, 2014, KKR Error Raises a Question: What Cash Should Go to Investors?

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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.

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.

Fund Investors: Due Diligence Questions

Similarly, to the extent that investors do consider fee and expense allocations to be material, or to the extent that they are a concern as a matter of principal, investors should ask fund managers about how they allocate fees and expenses before making an investment. Investors also should not hesitate to ask for concrete information about the actual expenses paid by funds and portfolio companies that the manager operated in the past. Examples of the types of questions that investors might ask include:

■ Which of the fund manager's associates are actual employees of the fund manager (the expense of which is borne by the fund manager), and which are ''consultants'' that are either paid compensation directly by the portfolio companies they advise or expensed to the fund? Will the fund manager be required to notify the investors of any change in status of employees to consultants?

■ If any consultant compensation is paid by the portfolio companies or the fund, does this compensation offset the fund manager's management fee?

■ Which expenses related to back office functions does the manager cover with its management fee and which expenses are paid by the fund or a portfolio company? Specifically, how are expenses related to regulatory compliance, legal, accounting and investor reporting functions paid?

■ If the fund manager operated a prior fund, what were the total expenses reimbursed by each portfolio company in that fund? Did those expenses offset the management fee? What types of compensation did the manager or its affiliates receive, if any, outside of the management fee or carried interest? What was the total fee and expense ''load''?

■ Does the manager expense private plane travel to the fund? Extravagant entertainment for ''marketing''? Other items that may be unacceptable to the investor as a matter of principle, even if potentially immaterial to returns?

■ Do all transaction fees earned by the manager or its affiliates offset management fees 100%?

Conclusion

Fund managers and investors should work together before a fund is lunched to ensure that investors receive adequate disclosure and understand the fees and expenses that they will bear. This disclosure will not only help set realistic expectations for investors, but will help fund managers avoid the specter of enforcement activity and possible sanctions, as well as potential exposure to investor-initiated lawsuits.

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