Private Equity Management
Fee and Expense Allocation and
Disclosures Amid Recent SEC Warnings
Evaluating Fee and Expense Policies, Procedures and Disclosures
to Ensure Compliance and Improve Investor Confidence

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Evaluating Fee and Expense Policies, Procedures and Disclosures to Ensure Compliance and Improve Investor Confidence

Strafford

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Roadmap/Outline

- SEC Presence Exam Initiative
- Findings of the SEC On Undisclosed Fees and Expenses
- SEC Enforcement Action Against Clean Energy Capital
- Best Practices for Investors: Due Diligence
- Best Practices for Fund Managers: Compliance and Internal Audit
- Q&A
Overview: The SEC 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).

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

Goal of Initiative: OCIE's Presence Exam Initiative was launched in October 2012 to engage and interact with the private equity industry. The main goal of the Initiative was to establish a presence within the private equity industry and to better assess the unique regulatory issues raised by the private equity business model.
Scope of Initiative and Examinations

- **Progress so far:** Under the Initiative, the SEC has examined more than 150 newly-registered PE advisors since October 2012.

- **Violations/weaknesses found (fees and expenses):** 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 various areas, and specifically with regard to the allocation of fees and expenses.

- **Violations/weaknesses found (disclosure):** 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.
Initiative Goals Going Forward

- **Continuing review/examination:** According to the OCIE the goal is to examine 25% of the new private fund registrants by the end of the year.

- **Projected increase in regulatory activity:** 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.

- **Projected increase in investor skepticism:** 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.
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Findings of the SEC on Undisclosed Fees and Expenses: “Spreading Sunshine in Private Equity”

- **The Spark:** What began this dialogue?

- **Title of Speech:** “Spreading the Sunshine in Private Equity” speech

- **Details:** Given by Andrew J. Bowden, Director, SEC Office of Compliance, Inspections and Examinations, on May 6, 2014 at the Private Equity International, Private Fund Compliance Forum

- **Cite:** The text of the speech can be found at: [http://www.sec.gov/News/Speech/Detail/Speech/1370541735361](http://www.sec.gov/News/Speech/Detail/Speech/1370541735361)
Findings of the SEC on Undisclosed Fees and Expenses: Payments to Consultants

- **Use of Consultants**: Also known as “Operating Partners.” Advisers promote these Operating Partners or Consultants as providing their portfolio companies with consulting services or other assistance that the portfolio companies could not independently afford.

- **Payments to Consultants without Disclosure**: Operating Partners or Consultants, who otherwise appear to be employees that the investors would expect the Adviser to pay out of the management fee, may be paid directly by portfolio companies or the funds without sufficient disclosure to investors.

- **Issues**: Investors may not realize that they are paying for Operating Partners or Consultants in addition to the management fee and carried interest. Could also be an issue that not offset against management fees.

- **In the News**: KKR/Capstone story run by Wall Street Journal 5/21/14
Findings of the SEC on Undisclosed Fees and Expenses: Shifting Expenses During a Fund’s Life

- **“Egregious” Case Re: Shift from “Employee” to “Consultant”:** Individuals presented to investors as employees of the Adviser during the fundraising stage were terminated and hired back as so-called “consultants” by the funds or portfolio companies.

- **“Egregious” Case Re: Billing for Back Office Functions without Disclosure:** OCIE has seen cases where advisers billed their funds separately for various back-office functions that have traditionally been included as a service provided in exchange for the management fee, including compliance, legal, and accounting — without proper disclosure.

- **More Common Cases:** OCIE sees advisers using process automation as a vehicle to shift expenses. Example: automation of the investor reporting function, with software costs borne by the fund rather than the adviser.
Findings of the SEC on Undisclosed Fees and Expenses: Characterization of Expenses

- **Partnership Agreements:** Many fund agreements are broad in the types of fees and expenses that can be charged to portfolio companies (as opposed to the adviser). This has created a gray area, which Director Bowden believes has allowed advisers to charge fees and pass along expenses that are not contemplated by investors.

- **Poor Disclosure:** Poor disclosure in this area is a frequent source of exam findings. OCIE has seen fund agreements lacking defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest.

- **Insufficient Information Rights:** OCIE believes that most fund agreements do not provide limited partners with sufficient information rights to be able to monitor their investments and their managers’ operations.
Findings of the SEC on Undisclosed Fees and Expenses – Hidden Fees

- **“Hidden Fees”**: Fees that are not adequately disclosed to investors.

- **Example: Accelerated Monitoring Fees**: Advisers often charge monitoring fees to portfolio companies in exchange for board and other advisory services during the portfolio company’s holding period. However, some advisers require the portfolio companies to enter into agreements to pay these fees for an indefinite term. Upon a sale, IPO or other similar transaction, the adviser then collects a potentially substantial fee to terminate those agreements. There is usually no disclosure of this practice when the agreement are signed, and the disclosure that does exist when the accelerations are triggered is “usually too little too late.”

- **Other Examples**: Charging undisclosed “administrative” or other fees not contemplated by the LPA; exceeding the limits set in the LPA around transaction fees or charging transaction fees in cases not contemplated by the LPA, such as recapitalizations; and hiring related-party service providers, who deliver services of questionable value.
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SEC Enforcement Action Overview: Clean Energy Capital

**Allegations:** The SEC contends that Clean Energy Capital, LLC (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.

- Alleged improper expenses included 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.

Clean Energy Capital: Key Takeaway: Disclosure

- Any undisclosed fees or expense allocations may be deemed to run afoul of the securities laws.
- Undisclosed fees and expense allocations put private equity fund managers at risk of
  - regulatory action
  - investor lawsuits
- … based on claims of purported fraud, misrepresentation, breach of fiduciary duty and breach of limited partnership agreements.
- 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.
Best Practices

- **Investors:**
  - **Due diligence.** Investors should ask fund managers about how they allocate fees and expenses before making an investment.

- **Fund managers:**
  - **Disclosure, compliance and internal audit.** Strong compliance programs and disclosure are paramount in preventing these issues from arising or, if occurring, from becoming increasingly problematic.
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Best Practices for Investors: Due Diligence Overview

- **Important Caveat:** There is much more to investor due diligence than a focus on fee and expense issues.

- **Materiality:** As a related point, not all investors necessarily believe that the fees and expenses on which Director Bowden focused are material.

- **Allocations:** 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. Some example questions are on the following slide.

- **Concrete Information Expense Loads in Adviser’s Past Funds:** 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.
Investor Due Diligence: Example Questions

- **“Employees” v. “Consultants”:** Which of the manager’s associates are actual employees of the manager (the expense of which is borne by the manager), and which are “consultants” that are either paid compensation directly by the portfolio companies they advise or expensed to the fund? Will the manager be required to notify the investors of any change in status of employees to consultants?

- **Consultant Fee Offset Against Management Fee:** If any consultant compensation is paid by the portfolio companies or the fund, does this compensation offset the manager’s management fee?

- **Allocation of Expenses:** 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?
Investor Due Diligence: More Example Questions

- **Prior Fund**: If the 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”?

- **“Luxuries”**: Does the manager expense private plane travel to the fund? If not, do they routinely fly first class, business class or coach? Do they engage in “extravagant” entertainment for “marketing”? Are there other items that may be unacceptable to the investor as a matter of principle, even if potentially immaterial to returns?

- **Transaction Fees**: Do all transaction fees earned by the manager or its affiliates offset management fees 100%?
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Best Practices for Fund Managers: Disclosure

- **Disclosure**: As discussed above, 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.

- **Golden Rule of Disclosure is Materiality**: 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.
  - Any undisclosed information runs the risk of being deemed “material.”

- **Specifics**: The offering documents should be very clear about which fund fees and expense and provide investors with sufficient information rights to adequately monitor their investments and the operations of the manager.
Best Practices for Fund Managers:
Compliance Programs and Internal Audit

- **Strong Compliance Programs:** Strong compliance programs and disclosure are paramount in preventing regulatory action and investor lawsuits from arising or, if occurring, from becoming increasingly problematic.

- **Internal Audit:** 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.
Best Practices for Fund Managers: Managing Risk

- **Consult with counsel:** 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.

- **Consider self-reporting if violation is discovered:** If appropriate and warranted, fund managers may consider self-disclosing the issue to investors and regulators, in connection with taking appropriate remedial steps.

- **Follow SEC guidance, not others in industry:** Even if certain practices are considered to be common within the industry, the SEC is sending a message regarding how it views such practices.