SEC Focus Results in Investment Adviser Fee and Expense Changes

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Recent efforts by the Securities and Exchange Commission (SEC) to bring concentrated regulatory attention to investment managers sharpened over the past year to include a particular focus on the private equity and hedge fund industry and on a variety of monetary arrangements between advisers and the funds they manage. Earlier this year, the SEC's Office of Compliance Inspections and Examinations formed a new group tasked with overseeing the private equity and hedge fund industries. That group cooperates with and complements the existing Asset Management Unit in the SEC's Division of Enforcement. Last year, those efforts resulted in public SEC pronouncements, including through enforcement actions, regarding fees and expenses charged by private funds and private fund advisers. Moreover, managers and investors have responded to the issues identified by regulators in ways that are altering past fee and expense practices.

Noteworthy SEC Compliance Inspection and Examination Updates From 2014

Jan 30
SEC holds the Compliance Outreach Program National Seminar, and Chairwoman Mary Jo White, in her opening remarks, identifies (1) expense shifting out of the management company and into funds, and (2) ancillary revenue such as transaction fees, which reduce cash to funds, in each case without proper disclosure or investor consent, among four major regulatory concerns in the private fund industry.

Feb 25
SEC institutes proceedings against Clean Energy Capital LLC (CEC) and its founder and CEO, Scott Brittenham, alleging in part that Brittenham inappropriately allocated expenses including rent, salaries and personal expenses, such as for estate planning and his daughter's school transportation, to investors. CEC and Brittenham later agreed to an approximately $2 million settlement.[1]

Apr 15
SEC files charges alleging that Total Wealth Management, Inc., its owner and its CEO failed to disclose revenue-sharing fees through which they paid themselves from investments they recommended to their clients.[2]

May 6
Director of the SEC's Office of Compliance Inspections and Examinations, Andrew Bowden, indicates in a speech that, after conducting more than 150 examinations of private equity firms, examiners identified what they believe are "violations of law or material weakness in controls" regarding collection of fees and allocation of expenses in over half of the firms examined.[3]

Q2
- Investors and potential investors in private funds enhance their due diligence regarding fee and expense issues, according to *The Wall Street Journal*.
- *PitchBook* reports that fewer than one-third of the transactions for this period included transaction or monitoring fees, in contrast to 90 percent of such transactions for the first quarter of 2012.

Jul - Oct
According to *The Wall Street Journal*, more than 15 private fund advisers revise their Form ADV filings midyear to provide additional disclosure regarding fee and expense practices, including accelerated monitoring fees, group-purchasing rebates not passed on to investors and allocation of costs associated with operating partners.

Sep 22
Lincolnshire Management Inc. (LMI) agrees to pay $2.3 million to settle charges by the SEC that it inappropriately allocated expenses relating to two portfolio companies between its private funds that owned these companies. The SEC alleged that LMI failed to follow its expense allocation policy in certain instances, resulting in a misallocation of funds.[4]

Oct 7
Blackstone indicates that it will curb its practice of charging accelerated monitoring fees in correspondence with a fund investor. *The Wall Street Journal* reports that the firm will no longer collect these fees when divesting companies and will distribute fees received in connection with companies already in its portfolio to investors or reduce other fees.

Dec 28
The Wall Street Journal reports that some of the largest private equity firms (including Blackstone, Apollo, KKR and Carlyle) will now pass transaction and monitoring fees to investors in full.

The SEC identified several practices that it asserts were implemented without adequate disclosure and investor consent and therefore resulted in deficiencies during exams, including:

- Moving expenses from the management company into funds through (1) the use of related-party service providers who appear to be part of the manager's team (e.g., operating partners, senior advisers or consulting firms); (2) automated standard processes with costs paid by the funds; and (3) outsourcing traditional back-office functions (such as legal, accounting and risk) to related parties;
- Generating additional revenues that reduce cash available to funds through (1) monitoring fees that accelerate and have evergreen provisions; and (2) use of related-party service providers that kick back cash to the manager and may provide services of questionable value (e.g., captive consulting firms and group purchasing programs);
- Charging undisclosed "administrative" or other fees not contemplated by the partnership agreement; and
- Exceeding the limits in the partnership agreement regarding transaction fees or charging transaction fees in cases not contemplated by the partnership agreement, such as for reorganizations.

Implications for 2015

In this new environment, general disclosure of fee and expense arrangements may be subject to challenge, particularly in situations where provisions appear ambiguous when judged in hindsight as failing to have adequately alerted investors to particular charges. Given the heightened investor scrutiny and the fiduciary issues raised by such scrutiny, advisers should ensure that (1) their initial and ongoing fee and expense disclosure is clear and complete; (2) their fee and expense practices are consistent with prior disclosure or they obtain investor consent; and (3) the substance of their practices is justifiable.

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[1] *Clean Energy Capital, LLC*, Securities Act Release No. 9667, Exchange Act Release No. 73,386, Investment Advisers Act Release No. 3955, Admin. Proc. No. 3-15776 (Oct. 17, 2014).

[2] *Total Wealth Management, Inc.*, Securities Act Release 9575, Exchange Act Release No. 71,948, Investment Advisers Act Release No. 3818, Investment Company Act Release No. 31,107, Admin. Proc. No. 3-15842 (April 15, 2014).

[3] Speech, Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, at the Private Equity International Private Fund Compliance Forum (May 6, 2014), *available at* www.sec.gov/News/Speech/Detail/Speech/1370541735361.

[4] *Lincolnshire Management, Inc.*, Investment Advisers Act Release No. 3927, Admin Proc. No. 3-16139 (Sept. 22, 2014).