The SEC And Private Funds: New Year, Same Focus

Brad Wilson
Partner
bwilson@stoneturn.com

Tristan Cecala
Manager
tcecala@stoneturn.com

The U.S. Securities and Exchange Commission ("SEC") announced its 2016 examination priorities in early January. As expected, the SEC will continue to focus on the allocation and treatment of fees and expenses and, specifically, potential conflicts of interest related to fees and expenses in its examinations of private fund advisers. Since the SEC is likely to pursue additional enforcement actions against hedge fund and private equity fund advisers related to fees and expenses in the coming year, we recommend taking a committed and proactive approach to compliance.

Introduction

In 2012, the SEC's Office of Compliance, Inspections and Examinations ("OCIE") began its Presence Exam Initiative pursuant to Dodd-Frank provisions requiring the registration of certain private fund advisers. The SEC has commented that one of the most common deficiencies identified as a result of the presence examinations is related to fee and expense allocation. In "Taking 'Private' Out Of Private Equity: 7 SEC Focus Areas,"[1] we highlighted issues likely to attract the SEC's attention in 2015, including the treatment of fees and expenses. The recently announced 2016 examination priorities indicate OCIE will maintain this focus.

New Year, Similar Focus

The SEC's recent comments and 2015 enforcement activity confirm the staff is focusing on several different issues related to fees and expenses. These issues, described below, are likely to be ongoing themes in 2016:

MARKET RATE: When fees for ancillary services are charged by the investment managers, it is often understood by investors, or even disclosed in a prospectus,

StoneTurn

that the fees will be at or below market rate. The SEC's examinations have identified issues both with the disclosure of the basis of these fees, as well as the manager's ability to substantiate the assertion that fees are at or below market rate. This issue is frequently encountered by real estate firms that are often more vertically integrated than traditional private equity managers and provide property management, construction management and other real estate management services. The SEC staff has stated that it rarely encountered a vertically integrated firm that could substantiate claims that such fees are "at market or lower."[2]

OVERHEAD EXPENSES: The commission has also observed that general and administrative expenses, as well as other overhead expenses, are frequently allocated to funds when these expenses should be borne by the fund manager. The SEC has stated that private equity advisers can only charge expenses to their funds when the expenses are clearly disclosed. For example, it brought an enforcement action against an adviser for charging rent, salaries, bonuses and other employee costs to its funds.[3]

BROKEN-DEAL EXPENSES: Broken-deal expenses represent due diligence or other deal-related expenses incurred on unsuccessful investments or buyout opportunities. In 2015, the SEC brought an enforcement action against a global private equity firm for inappropriately allocating the entirety of broken-deal expenses to its private equity funds rather than allocating the expenses between the funds and their co-investors. The SEC determined that, because co-investors did not share in the broken-deal expenses and due to the absence of a disclosure to the limited partners of the fund, the firm misallocated the broken-deal expenses in violation of the Advisers Act.[4]

FEE OFFSETS: The SEC has also observed instances in which private fund advisory fees were not appropriately offset by other fees earned by the manager from portfolio companies, such as consulting or monitoring fees. The SEC alleged in a 2015 enforcement action that a private equity firm inappropriately structured consulting arrangements with portfolio companies and avoided offsetting management fees with the revenue earned from the consulting arrangement.[5]

DISCOUNTED EXPENSES: In another 2015 enforcement action, the SEC raised potential conflict of interest concerns with discounts from vendors that provide services to both an adviser and its funds. In this action, the SEC alleged that a private equity firm failed to disclose the fee arrangement with its outside law firm and the adviser received a greater discount on services from the law firm than the discount provided to the funds, even though the funds generated significantly more fees than the adviser.[6]

COMPLIANCE-RELATED EXPENSES: In November 2015, the SEC brought an enforcement action against a private equity fund adviser for allegedly charging the adviser's legal and compliance expenses to its managed funds. These expenses resulted from the adviser's preparation for registration with the SEC, preparing for an OCIE examination and responding to an investigation by the SEC's enforcement division. While the funds' limited partnership agreements allowed for charging the funds for their own legal and consulting expenses, the SEC found no disclosure that the funds would be charged for the adviser's legal and compliance expenses.[7]

In addition to the issues surrounding the allocation of fees and expenses, the 2016 examination priorities also identify the controls and disclosures associated with side-by-side management of performance-based and asset-based fee accounts. Specifically, the SEC will focus on the potential conflicts of interest in managing accounts with different fee structures, including the potential that advisers will favor accounts that generate higher fees.

A common theme for many of the issues: managers are not maintaining adequate records or support for allocations and charges made to funds, and there are insufficient accounting and review controls and processes.

Preparing For Continued Scrutiny

2016 examination priorities and recent enforcement activity confirm the SEC's scrutiny of expense and fee practices of private fund managers will continue. A private fund manager can defend against such scrutiny through the implementation of a robust compliance program and ongoing testing and assessments of existing plans. The SEC's view is that a robust compliance program helps advisers to ensure their clients are not disadvantaged and receive full disclosure about how fund expenses are allocated. The implementation and assessment of such a program would include reviewing existing practices, assessing compliance risks, evaluating and improving internal controls, assessing disclosures, and establishing ongoing monitoring around fees and expenses, with a particular focus on the areas that have been highlighted by the SEC's recent activity.

Conclusion

Firms and managers should look outside their organization for assistance to conduct compliance assessments. Even organizations with strong compliance programs will benefit from an independent evaluation and testing of the design and operating effectiveness of its compliance-related controls over fees and expenses.

The SEC and other regulators are likely to look positively at firms that commission independent compliance assessments. The acting OCIE director has specifically noted the SEC is "encouraged to learn that many advisers are increasingly retaining consultants to evaluate their fee practices."[8] Overall, a committed and proactive approach to compliance will provide greater assurance to both investors and regulators.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] http://www.law360.com/articles/679592/taking-private-out-of-private-equity-7-sec-focus-areas

[2] https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html

[3] http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540849548

[4] http://www.sec.gov/news/pressrelease/2015-131.html

[5] http://www.sec.gov/news/pressrelease/2015-250.html

[6] http://www.sec.gov/news/pressrelease/2015-235.html

[7] https://www.sec.gov/litigation/admin/2015/ia-4258.pdf

[8] https://www.sec.gov/news/speech/private-equity-look -back-and-glimpse-ahead.html

All Content © 2003-2016, Portfolio Media, Inc.

This article was initially published in
Law360 in January 2016

Leaving no stone unturned.

StoneTurn.com

StoneTurn is a leading forensic accounting, corporate compliance and expert services firm that assists attorneys, corporations and government agencies on a range of high-stakes legal and risk-related issues. With professionals located in offices across the U.S. and U.K., and a network of senior advisers in numerous other countries, we provide expertise in: Litigation, Investigations, Compliance & Monitoring, Valuation, Forensic Technology and Data Analytics.

© 2017 StoneTurn Group, LLP, including its licensees, employs CPAs, but is not a certified public accounting firm. All Rights Reserved.

StoneTurn