SEC Continues to Scrutinize the Adequacy and Transparency of Private Equity Fees and Conflicts of Interest

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The Securities and Exchange Commission ("SEC") has continued to scrutinize the fees and expenses charged by private equity funds to investors, as evidenced by the recent enforcement action against three private equity funds advisers within the Blackstone Group, L.P. ("Blackstone"), charging them with failure to properly disclosure certain fees. Blackstone settled the matter on October 7, 2015, agreeing to pay nearly $39 million, including $10 million in penalties.

This settlement follows the SEC's enforcement action against Kohlberg Kravis Roberts & Co. ("KKR") charging KKR with the misallocation of over $17 million in "broken deal" expenses in breach of its fiduciary duty, which KKR settled in June 2015 for nearly $30 million. These recent enforcement actions against two of the largest and most prominent private equity funds represent an increased level of attention from regulators in connection with the fees charged to investors.

Andrew J. Ceresney, Director of the SEC's Division of Enforcement, was quoted as saying that "[f]ull transparency of fees and conflicts of interest is critical in the private equity industry and we will continue taking action against advisers that do not adequately disclose their fees and expenses, as Blackstone did here," indicating that future enforcement in this area is likely.

As a result of this scrutiny, private funds should carefully review the adequacy of disclosure of fees and expenses charged to investors and portfolio companies, identify potential conflicts of interest, and consider increasing transparency and taking remedial action where necessary.

Blackstone Settlement Order

The first issue highlighted in the settlement order relates to the acceleration of monitoring fees. Blackstone would typically enter into monitoring agreements with the various portfolio companies owned by the Blackstone-advised funds, under which Blackstone received an annual fee for certain consulting and advisory services. These fees were in addition to management fees paid by the funds' investors to Blackstone. Thought the monitoring fees were disclosed and authorized in the various fund documents, the SEC asserted that Blackstone failed to adequately disclose the fact that it had the right to accelerate the payment of future monitoring fees under certain circumstances (such as upon the private sale or IPO of a portfolio company), even though Blackstone would no longer perform services after such date, thereby reducing the amount available to be distributed to investors. The SEC took issue with the fact that the accelerated fees were only disclosed after they were paid, and not before investor committed capital to the funds.

The second matter involves disparate legal fee discounts. Blackstone's outside law firm performed a substantial amount of work for both Blackstone and the various funds in question. In the settlement order, the SEC states that Blackstone negotiated a single legal services arrangement with its law firm whereby Blackstone would receive a discount from the law firm that was substantially greater than the discount provided to the funds, and that the disparate discounts were not adequately disclosed to investors.

The SEC stated that Blackstone could not consent to the two practices in question because of its conflict of interest as recipient of the fees. Moreover, the SEC concluded that Blackstone breached its fiduciary duty to the various funds in violation of the Investment Advisers Act of 1940 (the “Advisers Act”), including provisions prohibiting advisers from engaging in practices that operate “as a fraud or deceit upon any client or prospective client,” or making “any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.” The SEC also claims that Blackstone was in violation for failure to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

The SEC acknowledged various remedial efforts that Blackstone had taken, including voluntarily ending the disparate legal fee structure and later disclosing the discount to investors. Furthermore, Blackstone enhanced its disclosure of fees relating to monitoring agreements and voluntarily limited the acceleration of certain monitoring fees. As part of the settlement, Blackstone neither admitted nor denied the SEC’s findings.

Conclusion

The high profile enforcement actions against Blackstone and KKR demonstrate that the SEC considers the disclosure of fees charged by private equity funds to be a high priority. In light of these recent events, funds should take steps to ensure greater transparency and disclosure of fees and conflicts of interest to investors and prospective investors. Though these recent enforcement actions were taken against private equity funds, these issues are relevant to many hedge funds and other funds with a similar structure.

Private funds should carefully review and evaluate the disclosure of fees and expenses charged to investors, including the indirect fees paid by portfolio companies which may limit the funds ultimately distributed to investors. Furthermore, funds should identify any potential conflicts of interests in the fee structure, such as payments between affiliated parties. To avoid potential liability or enforcement actions, funds should enhance disclosure in the documents furnished to investors and prospective investors when necessary or appropriate, and should otherwise increase the level of transparency in general. In addition, funds should ensure that written policies and procedures are in place to prevent violations of the Advisers Act.

If investment advisers identify fees for existing funds that may not have been properly disclosed to investors, they could consider taking remedial efforts, such as retroactively providing a detailed disclosure of the fees to investors or voluntarily waiving such fees.