Private Funds
Alert

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Recent SEC Settlement Underscores Continued Enforcement Focus on Management Fee Practices

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The SEC recently announced a settlement with a middle market private equity fund adviser alleging that the firm breached its fiduciary duties in connection with management fee offset calculation practices.[1] The SEC found that these practices created an undisclosed conflict of interest and were inconsistent with the relevant Limited Partnership Agreements (LPAs) between the adviser and the funds.

The findings in the SEC's settled order (Order) reflect the SEC's continued focus on management fee practices, particularly at a time when the SEC is making private funds more accessible to retail clients.

Background

The SEC's order found that the adviser engaged in two inappropriate fee offset calculation practices.

As background, and as is typical, the LPAs at issue allowed the adviser to collect management fees from the funds and transaction fees from portfolio companies, and further provided for a fee offset of the management fees owed by the funds for 100% of the transaction fees received by the adviser, subject to certain exclusions.

Several management services agreements between the adviser and portfolio companies held by the funds provided that payments of transaction fees to the adviser could be deferred if (i) the adviser in its sole discretion elected to defer payment of the fees, or (ii) loan covenants applicable to the portfolio company required deferral of the fees. The agreements also permitted the adviser to charge interest on deferred transaction fees at an 8% annual rate. Importantly, certain LPs of the funds that were also co-investors in portfolio companies received copies of the management services agreements and thus would have been aware of the potential deferral; otherwise, LPs in the funds did not receive these agreements or disclosure regarding such deferral.

The Order found that in instances where transaction fees were deferred, the management fees were higher because they were not offset by the deferred transaction fees. When the adviser later received the transaction fees and interest payments, it included in the fee offsets the transaction fees but not the interest. The Order likened this arrangement to "interest-free loans" from the funds to the adviser. While the LPAs described types of compensation or revenue that could be excluded from the fee offset, the interest on deferred transaction fees was not among the listed exclusions.

[1] https://www.sec.gov/enforcement-litigation/administrative-proceedings/ia-6908-s

For this first violation, the SEC found that the adviser did not adequately disclose the practice of collecting interest on deferred transaction fee payments by the portfolio companies, nor did it disclose that interest was excluded in the corresponding fee offsets.

For the second violation, the SEC found that for at least one portfolio company in which multiple funds were invested, the adviser improperly double-counted transaction fee reductions, further lowering each fund's fee offset. The adviser initially allocated to each fund "a portion" of the transaction fees received based on each fund's pro rata share of capital invested, rather than allocating all transaction fees received by the adviser. The adviser then reduced the allocation again based on each fund's fully diluted equity ownership of the portfolio company. The Order found that this calculation was contrary to the terms of the LPAs.

Analysis

- Close Attention to Management Fee Offsets. This action demonstrates the SEC's continued focus on and close examination of management fee offsets, and in important ways is in line with Enforcement actions involving private fund advisers over the past decade. The deep focus on offset mechanics also reflects what we have observed the past few years during SEC examinations. As reflected in the SEC's release accompanying the Order, staff from the Divisions of Examinations' Private Funds Unit and Division of Enforcement's Asset Management Unit collaborated on the investigation, which has become a typical SEC approach to enforcement investigations involving private fund advisers.
- Silence in the LPA Is Not Necessarily Authority. The SEC did not dispute the adviser's authority to defer payments of transaction fees. According to the Order, however, the LPA did not discuss whether interest could be charged on the deferred payments, and if so, what would happen to that interest. The Order further noted that interest on deferred transaction fees was not among the permissible types of compensation or revenue that could be excluded from the fee offset. SEC staff are laser focused on any benefit to the adviser beyond what is explicitly describe in the LPA.
- Conflict of Interest Framing. The Order framed the deferred transaction fee issue as a conflict of interest, presumably because the adviser had an incentive to defer transaction fees, which according to the Order "effectively resulted in interest-free loans from the [funds]." This supports the staff's Section 206(2) finding, which prohibits an investment adviser from engaging in any transaction, practice or course of business that operates as a fraud or deceit upon a client. Under the staff's view, the adviser appears to have two choices in these situations: either let the fund benefit from the interest collected or disclose to all LPs the financial benefits and the conflict to investors.
- SEC Will Pursue Negligence-Based Violations under Section 206(2). It is also worth noting that the SEC is willing to prioritize not just scienter-based violations of Section 206. The settlement, which charges a negligence-based violation, stands in contrast to a litigated action filed the day before the settlement. In that other matter, the SEC filed a litigated complaint against a portfolio manager for violating his fiduciary duty to his private fund client, including by directing the fund client to purchase portfolio company notes without disclosing his significant personal investment in the business. The complaint also alleges the adviser failed to act in the fund client's best interests by causing it to substantially increase its investments in the notes despite red flags that some of the purported collateral may have been fabricated.

- Rule 206(4)-8 in Limbo. While this action confirms that the Commission is prepared to charge an adviser with negligence-based violations under Section 206(2), it is not clear the same can be said for Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which makes it unlawful for any investment adviser to a pooled investment vehicle to make a materially false or misleading statement to, or otherwise engage in “any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.” It is notable that the staff did not frame the conduct as a violation under Rule 206(4)-8, in addition to Section 206(2), which would have been consistent with enforcement actions under prior Commissions. There are some possible explanations. Chairman Atkins, during his prior time as a Commissioner, publicly expressed a then-dissenting view that Section 206(4), which provides authority for Rule 206(4)-8, requires scienter. Even though both the SEC and the courts have treated the statute and the accompanying rule as requiring only negligence, it is possible the SEC staff is treading lightly around this topic for the time being. And because the staff was able to frame both violations under Section 206(2), it is possible that there was nothing additive about the Rule 206(4)-8 charge and so not necessary for this action. It is too early to tell whether this Commission will avoid Rule 206(4)-8 in negligence-based cases. But if the Commission were to require scienter for Rule 206(4)-8, that would elevate the standard for finding violations involving pooled investment vehicles in connection with misstatements in offering documents or oral statements to investors, which are not typically actionable under Section 206(2) without a misstatement in the LPA.
- Materiality and Penalty. The management fees at issue here amount to more than $500,000 across multiple funds, with multiple LPs in each fund. This should put to rest any question about whether this Commission will have a high threshold for what it deems to be a material breach of a fiduciary duty under Section 206(2). The SEC staff historically often views the mere fact of not following the terms of an LPA as to financial benefit to be a material term, even if the dollars are not significant. The penalty in this case ($175,000, along with disgorgement and interest of approximately $509,000), though, appears to be lower than penalties against private fund advisers under prior Commissions. While penalties are often bespoke given the particular facts of each case, the relatively lower penalty here seems consistent with messaging coming from this Commission and its staff on penalties.
- Retailization in Mind, Perhaps. The action corresponds with the SEC’s recent move to allow more retail money into private funds. The SEC may seek to continue pursuing examinations and investigations of opaque practices at private fund advisers in order to make private funds “safer” for less sophisticated investors.

Final Takeaway for Advisers

This Enforcement action demonstrates that there is an affirmative requirement on investment advisers to disclose conflicts even where underlying documents are silent on the topic. An adviser’s silence on a matter within an LPA or another disclosure document can be interpreted against it when the matter involves a financial benefit to the adviser. Advisers should continue to compare their management fee offset language with their actual practices. If there is any arguable daylight between the two, the adviser should evaluate how to address the issue.

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