Private Fund Manager and its Executives Settle SEC Enforcement Case for Conflict of Interest Disclosure Failures

On November 3, 2015, the SEC entered into a consent order with a private equity fund manager and four of its executives for disclosure failures relating to conflicts of interest arising out of the manager's conversion of partially offsettable portfolio company monitoring fee payments to non-offsettable payments to a manager-affiliated consulting firm and former manager employees.

Conversion of Monitoring Fees

The consent order described the following:

- The manager entered into management services agreements ("MSAs") with certain portfolio companies under which the companies paid monitoring fees to the manager for consulting and business management services.
- Under the fund's organization documents, monitoring fees payable to the manager were 80% offset against fund management fees payable to the manager.
- The manager and four of its executives (including the CCO) caused certain fund portfolio companies to terminate their MSAs and enter into consulting agreements with a manager-affiliated firm to provide similar consulting and business management services, using the same fee structure and many of the same employees previously employed by the manager.
- The consulting fees received by the manager-affiliated consulting entity were not offset against fund management fees, resulting in the fund paying a larger management fee to the manager.
- In addition, a fund portfolio company made significant incentive equity grants to former executives and employees of the manager shortly before the company was sold, in consideration for services provided, to a significant extent, when they were employed by the manager. These equity incentive payments were not offset against fund management fee.

Disclosure and Related Failures

The consent order noted the following manager disclosure and related failures under the Advisers Act:

- Failure to disclose to the fund advisory board the manager's conflict of interest resulting from conversion of monitoring fees payable to the manager and subject

to 80% management fee offset to consulting fees payable to a manager-affiliate but not subject to any management fee offset.[1]

- Material omissions for failing to identify the payments to the manager-affiliated consulting firm in (1) manager communications with the fund advisory board, (2) manager capital call notices to fund limited partners, and (3) fund financial statements as a related party transaction.

- Inherent manager conflict of interests because the consulting payments were not authorized in the fund's organizational documents and the manager could not, due to such conflict, consent to the payments not subject to the management fee offsets.

- Failure to disclose to the fund advisory board the incentive equity grants to former manager executives/employees in connection with the portfolio company sale.

- Omissions for failing to identify the incentive equity grants in (1) communications to limited partners following the portfolio company sale, and (2) fund financial statements as a related party transaction.

Disgorgement and Penalties

Without admitting or denying the findings, the manager and the executives agreed to a cease and desist, censure, disgorgement of $7.9 million plus prejudgment interest and penalties totaling over $1.5 million.[2]

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This settlement emphasizes the current SEC enforcement focus on private fund manager conflicts of interest and related disclosure issues, in particular related-party transactions that benefit the manager or their executives at the expense of fund clients when (a) the arrangement is not authorized in the fund organizational documents or (b) the manager does not mitigate the conflict by, e.g., seeking advisory board or investor consent following disclosure of all material facts.

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1 The order notes that under the fund's organization documents, the fund's advisory board had the "authority and responsibility to approve or disapprove" of certain items including "direct and material conflict[s] of interest."

2 The SEC found, among other violations, that the adviser and its executives violated the antifraud provisions of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8, which make it unlawful for any fund adviser to make any false or misleading statement of material fact to any fund investor or to engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any fund investor. Such violations may rest on a finding of simple negligence.

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