The SEC's Evolving Scrutiny of Private Equity Firms: KKR Hit with an Unprecedented Enforcement Action for Broken Deal Expense Misallocation

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On June 29, 2015, the US Securities and Exchange Commission ("SEC") charged Kohlberg Kravis Roberts & Co. ("KKR") with misallocating more than US$17 million in broken deal expenses to its flagship private equity funds in breach of its fiduciary duty as an SEC-registered investment adviser. KKR agreed to pay nearly US$30 million to settle the charges. This action represents a continuing and robust focus by the SEC on fee and expense allocation practices and disclosure by private equity fund advisers, many of which are relatively newly registered with the SEC following passage of the Dodd-Frank Act. It serves as a reminder of the need for private equity firms and other advisers to private investment funds to consider bolstering their compliance and disclosure policies and procedures related to the allocation of fees and expenses.

Background

In October 2012, the SEC, through its Office of Compliance Inspections and Examinations ("OCIE"), began its Presence Exam Initiative ("Initiative") to better assess the issues and risks presented by the private equity industry's business model. In particular, the SEC has focused examination and enforcement efforts on how private equity fund advisers disclose the allocation of fees and expenses to their investors.[1] The SEC previously reported that it has examined more than 150 newly-registered private funds (who registered following passage of the Dodd-Frank Act and its fund registration requirements), and that the majority of them have either violated the law or have demonstrated material weaknesses in their controls related to the allocation of fees and expenses. Areas of particular concern for the SEC have been payments to consultants, expenses shifted from a fund manager to the fund after the fund's inception, characterization as fund expenses of expenses traditionally thought to be paid by the fund manager out of management fees, and hidden fees.

The SEC's recent action against KKR is part of a suite of enforcement actions taken by the SEC in relation to private equity and hedge funds, including with respect to alleging improper expense allocation

[1] Please see our prior client advisory titled "Private Equity Management of Fees and Expenses: A Cautionary Tale," available here, for further details on the SEC's initiation of its Presence Exam Initiative.

and hidden fees. On October 17, 2014, Clean Energy Capital, LLC and its main portfolio manager agreed to pay US$2.2 million to settle an enforcement action with the SEC related to the misallocation of fees and expenses (employee salaries, executive bonuses, health benefits, retirement benefits, and rent). Likewise, on September 22, 2014, Lincolnshire Management, Inc. agreed to pay US$2.3 million to settle an enforcement action with the SEC related to the misallocation of fees and expenses (administration expenses, employee salaries, overhead costs, and executive bonuses).[2] As with these prior cases, a review of the settlement between KKR and the SEC helps provide guidance as to how private equity firms can bolster their compliance and disclosure practices, policies, and procedures. It can also help them be more proactive in detecting issues of concern to the SEC and working cooperatively with SEC examination staff to minimize the cost, distraction, and penalties of an enforcement action, which can be substantial, especially when considered in relation to the amount of fees that typically are at issue.

KKR's Allocation Practices and SEC Settlement

According to SEC documents, KKR incurred US$338 million in broken deal or diligence expenses related to unsuccessful buyout opportunities and similar expenses during a six-year period ending in 2011. These expenses related to potential investments by KKR's flagship funds ("Flagship PE Funds"), which raise capital from many large pension funds, university endowments, and other large institutional investors and high net worth individuals. KKR also raised capital from co-investors, which included KKR executives, consultants, and others, in co-investment funds ("KKR Partner Vehicles").

Consistent with industry practice at the time, a point recognized by the SEC, the limited partnership agreement ("LPA") for KKR's largest private equity fund ("2006 Fund") requires the 2006 Fund to pay "all" broken deal expenses[3] "incurred by or on behalf of" the fund "in developing, negotiating and structuring prospective or potential [i]nvestments that are not ultimately made."[4] However, as emphasized by the SEC, "neither the 2006 Fund's LPA nor any other offering materials related to the 2006 Fund included any express disclosure that KKR did not allocate broken deal expenses to KKR Co-Investors even though those vehicles participated in and benefited from KKR's general sourcing of transactions."[5]

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[2] Please see our prior client advisory titled "New Developments in the SEC's Focus on Private Funds," available here, for further details on these settlements.

[3] Broken deal expenses, as specified by the SEC, include research costs, travel costs, and professional fees and other expenses incurred in deal sourcing activities related to specific "dead deals" that never materialize. Broken deal expenses also include expenses incurred to evaluate particular industries or geographic regions for buyout opportunities as opposed to specific potential investments, as well as other similar types of expenses.

[4] Kohlberg Kravis Roberts & Co., L.P., SEC Order, File No. 3-16656 (June 29, 2015).

[5] *Id.*

KKR later revised its allocation methodology in 2012 following a third-party consultant review amidst the SEC's heightened public scrutiny of the private equity industry. The new methodology, which the SEC expressly noted is not subject to its action, allocates or attributes a share of broken deal expenses to co-investors based on a number of factors, including the amount of committed capital, the amount of invested capital and the percentage of transactions in which co-investors were eligible to participate given Flagship PE Funds' minimum investment rights. The SEC noted with disfavor that KKR did not adopt and implement a written compliance policy or procedure governing broken deal expense allocation practices until 2011, more than two years after it registered with the SEC as an investment adviser.

Based primarily on the failure to adopt a broken deal allocation methodology prior to 2011, as well as the failure to disclose that broken deal fees would not be allocated to co-investment funds, the SEC charged KKR with violating Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder. Without admitting or denying the SEC's allegations, KKR settled with the SEC and agreed to pay nearly US$30 million.[6]

Important Lessons and Next Steps for Private Equity Firms

There are important lessons private equity firms can take away from the SEC's action against KKR:

- **Compliance and Disclosure Review.** Private equity firms may wish to generally review both their compliance program with respect to fee and expense allocation and their related offering materials and partnership agreements. As noted by Marshall S. Sprung, Co-Chief of the SEC Enforcement Division's Asset Management Unit, "[a] robust compliance program helps investment advisers ensure that clients are not disadvantaged and receive full disclosure about how fund expenses are allocated."[7]

- **Remediation and Cooperation.** As noted in the SEC's settlement order with KKR, the SEC considered remedial acts taken by KKR and cooperation afforded by KKR to SEC staff during the OCIE compliance examination and subsequent investigation. It is not uncommon for the SEC to reward firms for being proactive in addressing an issue once it has arisen, and for working cooperatively with SEC staff, although the impact of this beneficial conduct on a settlement may not be quantifiable.

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[6] Specifically, KKR agreed to pay more than US$14 million in disgorgement (US$3.26 million was previously refunded to clients) as well as more than US$4.5 million in prejudgment interest and a US$10 million civil money penalty.

[7] Press Release, SEC (June 29, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-131.html.

Conclusion

This recent enforcement action taken against KKR, as with prior ones taken in the fee and expense allocation context against others, represents a continuing focus of the SEC on fee and expense misallocation. Given this focus, it seems likely that more enforcement actions are to come. On a positive note, the settlement further clarifies the SEC's expectations for private equity firms with respect to fee and expense allocation and demonstrates that good faith remediation may mitigate the severity of any enforcement action. The settlement also is relevant to advisers to real estate and hedge fund complexes that face similar allocation issues. With increased SEC scrutiny of fee and expense allocation issues, institutional investors also now are focusing on these issues, and may in part base investment decisions on them. Therefore, for many reasons, it would be prudent for private equity firms and other advisers to private investment funds to re-evaluate their fee and expense allocation policies and procedures to be sure that they adhere to current regulatory and investor expectations.

If you have any questions about any of the topics discussed in this advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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