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Financial Services and Markets

Expensive Mistakes

On 29 June 2015, KKR paid almost $30 million to settle charges brought by the US Securities and Exchange Commission (SEC) in relation to alleged misallocation of "broken deal" expenses to its flagship funds. In this note, we summarise the basis for the SEC charges and analyse whether this US enforcement action has potential ramifications for private equity and asset management firms regulated in the UK.

The SEC enforcement action

Between 2006 and 2011, KKR's affiliated co-investment vehicles invested approximately $4.6 billion alongside approximately $30 billion invested by its flagship funds. During that time, KKR incurred over $300 million in broken deal expenses. These expenses were allocated to the flagship funds only; the co-investment vehicles did not bear any proportion of these expenses even though they were benefitting from KKR's activities in identifying appropriate investment transactions. Importantly, neither the fund agreement nor the offering documents for the flagship funds indicated that this would be the case.

In 2013, an inspection visit by the SEC identified this issue and concluded that the failure to disclose had resulted in the misallocation of $17.4 million in expenses to the flagship funds in breach of KKR's fiduciary duty. KKR neither admitted nor denied the SEC's findings, but agreed to pay almost $19 million in voluntary compensation to investors and a $10 million penalty.

For those who have been paying attention to various SEC speeches over the last two years, the enforcement action against KKR may not come as a particular surprise. In May 2014, Andrew Bowden's "*Sunshine*" speech indicated that, where SEC examiners had looked at how fees and expenses were handled by private equity firms, what they believed to be violations of law or material weaknesses in controls were identified over 50% of the time. These included improperly shifting expenses to the funds, charging hidden fees and failures in policies and procedures or disclosure to investors.

This theme was picked up in Julie Riewe's speech, "*Conflicts, Conflicts Everywhere*", in February 2015. Ms Riewe noted that the SEC was expecting to see more cases involving undisclosed and misallocated fees in the context of private equity fund managers. She also emphasised that these failures were part of a broader pattern of managers failing to discharge their fiduciary obligations through their failure to address conflicts of interest in their business models.

Most recently, Marc Wyatt's speech in May 2015, "*Private Equity: A Look Back and a Glimpse Ahead*", reiterated that expenses and expense allocation remained a priority. Mr Wyatt warned that *"[m]any managers still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty*", noting that the practice of allocating expenses away from friends and family vehicles to the main funds was difficult for investors to detect but easy for SEC examiners to test.

Implications for UK-regulated firms

Where the SEC leads, other regulators often follow. In its 2015/16 business plan, the FCA stated that it is intending to launch a market study on asset management which will focus in particular on the charges paid by investors and the factors driving those charges. In the past, the FCA has used thematic reviews to target areas where it is concerned that firms may not be applying the existing rules correctly or where industry standards are below supervisory expectations. In addition, given the significant publicity surrounding this enforcement action, firms' approaches to expense allocation are likely to come under increasing scrutiny from fund investors.

The FCA rules do not expressly address the allocation of expenses between funds but UK-regulated firms are, of course, subject to rules on conflicts of interest that are relevant in this type of situation. These rules require identification, management and disclosure of conflicts, whether between the firm/its personnel and its clients or between different clients. In some cases the inducements rules (which limit, among other things, the circumstances in which firms may pay fees to third parties in connection with client business) may also be relevant. Firms authorised under AIFMD are additionally subject to rules requiring information on costs and charges to be provided to investors prior to investing in the fund and fair treatment of investors generally.

As a result, it would be advisable for firms to ensure:

- they are satisfied that their investors understand the costs and charges borne by the funds in which they invest;

- they have identified and appropriately managed (or, where that is not possible, disclosed as required) any relevant conflicts; and
- the procedures by which they allocate costs and expenses to funds do in fact reflect the policies agreed with investors.

The SEC's press release in relation to the enforcement action against KKR is here:
http://www.sec.gov/news/pressrelease/2015-131.html

For detailed advice on the matters discussed above please contact any of the financial services and markets partners named below or your usual FSMD contact.

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