SEC Enforcement Continues to Target Private Fund Advisers for Improper Fee Allocation

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Making clear that it remains focused on misallocation of fees and expenses by private fund advisers, the SEC last week brought a settled administrative proceeding against Monomoy Capital Management, L.P., a New York-based private equity fund adviser, for allegedly charging portfolio companies of one of its funds for operations-related services without adequate disclosure. The case, in which Monomoy agreed to pay disgorgement, a penalty and prejudgment interest totaling nearly $2 million, is the latest in a series of SEC enforcement actions against private equity firms in recent years alleging failure to disclose fees and resulting conflicts of interest to investors.

Inadequate Disclosure

According to the SEC's order, Monomoy used its in-house Operations Group to help its portfolio companies make business improvements, and highlighted the Group's role and value to the portfolio companies in the private placement memorandum for the fund at issue ("Fund II") and in a due diligence questionnaire provided to all Fund II investors. Rather than covering the costs of running the Group from its management fee, the SEC found that, between April 2012 and December 2016, Monomoy charged the portfolio companies an hourly rate in order to recoup most of those costs. The reimbursements were significant, amounting to more than 13 percent of the overall revenue Monomoy took in with respect to Fund II.

The SEC determined that Monomoy failed to "fully and fairly" disclose these fees and the resulting conflicts of interest. As alleged in the order, before 2014, Monomoy disclosed neither that the Operations Group was providing billable services to portfolio companies nor that the companies were reimbursing Monomoy for those services. While the governing Limited Partnership Agreement identified several specific fees for which the portfolio companies were responsible (including closing, investment banking, placement, monitoring, consulting, directors and "other similar fees"), it made no mention of the Operations Group or of the fees charged to portfolio companies to compensate Monomoy for the Group's services.

In March 2014, Monomoy disclosed in its Form ADV that "under specific circumstances, certain Monomoy operating professionals may provide services to portfolio companies that typically would otherwise be performed by third parties," and that Monomoy "may be reimbursed" for the costs of those services. This language was inadequate, the SEC found, because it did not inform Fund II investors that Monomoy did in fact provide such services and actually received reimbursement from the portfolio companies. Moreover, the order noted, Monomoy did not disclose these facts in the Summary of Material Changes in its ADV. Based on these alleged failures, the SEC charged Monomoy with violating Section 206(2) of the Investment Advisers Act.

Takeaways

In addition to signaling that this issue remains a priority for the SEC, the Monomoy order underscores the agency's now well-established view that hypothetical disclosures that a fund adviser "may" receive fees, or that conflicts of interest "may" result, are insufficient where the adviser does in fact receive such fees. (The SEC set forth this position explicitly in the interpretive guidance it issued last June on the fiduciary duty of investment advisers.) Accordingly, advisers should avoid using such equivocal language when disclosing fees, costs, revenue-sharing arrangements with third parties, or other existing conflicts.

Also notable, the SEC credited Monomoy with cooperation in its investigation, including "voluntarily and promptly" providing documents and information, meeting with the staff several times, and providing "detailed factual summaries" of relevant information (but not, apparently, self-reporting its conduct to the SEC). Monomoy's perceived cooperation may have led the SEC not to bring charges against the firm for inadequate policies and procedures under Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which it typically has brought along with Section 206(2) charges in prior actions. The Monomoy order thus may provide advisers with a basis for seeking similar credit where they can demonstrate prompt and fulsome cooperation with the SEC's voluntary investigative requests.

Finally, given the current Commission's emphatic focus on retail or "Main Street" investors, the order's observation that the limited partners of Fund II included not only institutional investors and high net worth individuals, but also pension funds, public employee retirement systems and charitable organizations, is significant. While private equity investors historically have not been associated with Main Street, the SEC has noted previously that retail investors in fact are widely exposed to private equity given the extensive investment of their retirement savings through the industry. The SEC's order in this case may therefore be a further indication that disclosure by private equity advisers will remain an enforcement priority under the "retail investor" theme.
