Clients&FriendsMemo

SEC Focus On Expense Allocation: In the Matter of KKR

July 9, 2015

On June 29, 2015, the SEC charged Kohlberg Kravis Roberts & Co. L.P. ("KKR"), an SEC-registered investment adviser, with misallocating more than $17 million in broken deal and diligence expenses to its flagship private equity funds in breach of its fiduciary duties under the Investment Advisers Act of 1940 (the "Advisers Act"). KKR agreed to a $10 million penalty and to pay more than $14 million in reimbursements. The settlement is a significant enforcement action with respect to the allocation of fees and expenses – an area that the SEC has indicated is one of regulatory focus for the industry.[1]

Summary of the SEC Action

The SEC found that from 2006 to 2011 KKR had incurred $338 million in broken deal or diligence expenses related to buyout opportunities that had not resulted in a transaction. These broken deal expenses included costs for research and travel and professional fees, as well as other expenses incurred in sourcing deals that never closed.

Although KKR's co-investors, who included KKR executives, participated in the firm's private equity transactions and benefited from the firm's deal sourcing efforts for deals that actually closed, the SEC found that KKR had not allocated to them any portion of the broken deal and diligence expenses for deals that did not close during a six-year period. Additionally, KKR did not expressly disclose in its fund limited partnership agreements or related offering materials that it did not allocate broken deal expenses to potential co-investors. In other words, the limited partners in the flagship funds were required to bear the full cost for virtually all the broken deal and diligence expenses.

---

[1] Two relatively recent enforcement actions highlight the SEC's increased focus. On October 17, 2014, Clean Energy Capital, LLC and its primary portfolio manager agreed to pay $2.2 million to settle an SEC enforcement action related to the misallocation of fees and expenses. Similarly, on September 22, 2014, Lincolnshire Management, Inc. paid $2.3 million to settle an SEC enforcement action related to the misallocation of fees and expenses.

This memorandum has been prepared by Cadwalader, Wickersham & Taft LLP (Cadwalader) for informational purposes only and does not constitute advertising or solicitation and should not be used or taken as legal advice. Those seeking legal advice should contact a member of the Firm or legal counsel licensed in their jurisdiction. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. Confidential information should not be sent to Cadwalader without first communicating directly with a member of the Firm about establishing an attorney-client relationship. ©2015 Cadwalader, Wickersham & Taft LLP. All rights reserved.

As a result, the SEC found that KKR had violated:

- Section 206(2) of the Advisers Act – which prohibits an investment adviser from directly or indirectly engaging in "any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client."

- Section 206(4) of the Advisers Act and Rule 206(4)-7 – which require a registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder (based on KKR's lack of a written expense allocation policy before 2011).

SEC Focus on Private Equity Funds

The KKR action could signal similar enforcement actions to come. The allocation of fees and expenses in private equity are on the 2015 Office of Compliance Inspections and Examinations' ("OCIE") priority list and Marc Wyatt, the OCIE's Acting Director, recently highlighted the area as one of continued scrutiny for the SEC. In light of the action against KKR, private equity firms would be wise to reevaluate their disclosures, recordkeeping, and expense allocation policies to ensure consistency between documentation and actual practices and to determine that their disclosures and practices meet the expectations of both regulators and investors.

* * *

Steven Lofchie
Partner, Cadwalader, Wickersham & Taft LLP
T.+1 212 504 6700
steven.lofchie@cwt.com

Dorothy Mehta
Special Counsel, Cadwalader, Wickersham & Taft LLP
T.+1 212 504 6846
dorothy.mehta@cwt.com

Allison Saltstein
Summer Associate Law Clerk, Cadwalader, Wickersham & Taft LLP
T. +1 212 504 6215
allison.saltstein@cwt.com