CLIFFORD CHANCE

RECENT SEC SETTLEMENT HIGHLIGHTS SEC'S CONTINUED FOCUS ON FEES & EXPENSES

On April 22, 2020, the United States Securities and Exchange Commission ("SEC") announced its latest settlement with a private equity fund manager, Monomoy Capital Management, L.P. ("Monomoy").[1] The order demonstrates the SEC's continued focus on disclosure of monitoring fees and expenses. In light of the SEC's continued focus on monitoring fee disclosure, fund managers should review their Form ADV, offering memoranda and related disclosures regarding fund expenses and fees to ensure those disclosures prominently and accurately identify fees and expenses that are borne by investors.

Monomoy's settlement with the SEC centers around Monomoy's use of in-house employees to provide support to portfolio companies. According to the SEC settlement, these employees were part of the "Operations Group" at Monomoy and provided services to portfolio companies.

The SEC alleged that Monomoy pitched investors on the benefits of its Operations Group in its private placement memorandum for Monomoy Capital Partners II, L.P. ("Fund II") and related due diligence materials, which stated that Monomoy had "built an extensive in-house operational and financial restructuring team" to assist portfolio companies.

Although Monomoy disclosed the existence of the Operations Group, the SEC alleged Monomoy failed to adequately disclose that the Operations Group charged portfolio companies for the service of its employees, allowing Monomoy to recoup most, but not all, of the operating expenses of the Operations Group.

The gravamen of the SEC settlement is inadequate disclosure of related party fees and attendant conflicts. However, looking at what Monomoy did disclose, it appears that the SEC continues to take an aggressive view of the granularity necessary to comply with Section 206(2) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Specifically, according to the SEC, Monomoy

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1 *Monomoy Capital Management, L.P.*, Investment Advisers Act of 1940 Release No. 5485 (April 22, 2020).

explicitly disclosed in its Fund II limited partnership agreement ("LPA") that Fund II would pay costs associated with "monitoring fees, consulting fees, directors fees and other similar fees," which would be partially offset against management fees unless they were for services provided to portfolio companies in the “ordinary course of business.” Such disclosures would, on their face, appear to sufficiently cover the services provided by the Operations Group, however, the SEC believed they were inadequate.

According to the SEC, these disclosures were inadequate because Monomoy did not provide *full and fair* disclosure that it would separately charge Fund II portfolio companies for the Operations Group service costs, nor did Monomoy disclose the attendant conflicts of interest with this arrangement. According to the SEC, because Monomoy did not specifically identify reimbursement of costs or conflicts related to the Operations Group in the LPA, such reimbursements were not adequately disclosed and thus violated Section 206(2) of the Advisers Act.

The SEC also noted the inadequacy of Monomoy's Form ADV disclosure. Monomoy's March 2014 Form ADV stated 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 costs related to such services. The SEC alleged that this was inadequate because, by March 2014, Monomoy "routinely provide[d] such services" and "did, in fact, receive reimbursements" for such services. Therefore, the SEC concluded that the Form ADV's disclosure of possible services "under specific circumstances" for which Monomoy "may be reimbursed" was not a full and fair disclosure.

One year removed from *Robare Group, Ltd*. *v. SEC*, 922 F.3d 468 (D.C. Cir. 2019), advisers need no longer wonder how the SEC interprets the D.C. Circuit's silence on whether a disclosure that an adviser "may" receive fees or compensation is sufficient disclosure of a conflict of interest when the adviser actually receives such fees or compensation. This settlement underscores that the SEC expects managers who charge or recoup such fees to affirmatively state they *are* being reimbursed rather than stating they *may* be reimbursed. Advisers should, therefore, carefully review Form ADV disclosures to ensure that if a practice of receiving fees or compensation occurs, that practice is disclosed with sufficient precision and detail to allow investors to evaluate any specific conflict.

Notably, Monomoy launched and raised Fund II before the Dodd-Frank Wall Street Reform and Consumer Protection Act repealed the "private adviser" exemption previously provided by Section 203(b)(3) of the Advisers Act, and, consequently, before it became subject to any obligation to prepare or deliver a Form ADV Part 2. Accordingly, investors in Fund II would not have been informed by any disclosure in Form ADV before making their decision to invest.

As a result of the SEC's finding of inadequate disclosure leading to a violation of Section 206(2) of the Advisers Act, Monomoy settled for a monetary penalty totaling $1,926,579, representing disgorgement of $1,521,972, prejudgment interest of $204,606, and a civil monetary penalty of $200,000.

This case does not stray far from established SEC precedent, but reinforces the risk that, even if fund offering documents or related disclosures indicate that a manager may charge or recoup monitoring fees, the SEC is likely to view the disclosure as inadequate unless it is unambiguous and precise in its description of the fees being charged and/or reimbursed by a fund or underlying portfolio companies and the conflicts thereto.

This case also highlights the SEC's continued scrutiny of direct or indirect revenue derived outside of an adviser's standard management fee. Where the adviser or its personnel or related affiliates receive fees or reimbursements, the SEC will scrutinize closely those arrangements and the adequacy of the related disclosures. If disclosure around these issues is not robust enough to allow a reasonable investor to sufficiently understand the practice at issue and the related conflicts in order to form a view on whether to consent or reject the practice, the disclosure is likely to be, in the eyes of the SEC, deficient and in violation of Section 206(2) of the Advisers Act.[2]

[2] Advisers acting to address potential conflicts as described in this case should be aware that the SEC specifically noted that Monomoy could not effectively consent to the practice on behalf of the fund. Therefore, advisers should carefully consider investor consent mechanisms, such as advisory boards, when analyzing potential or actual conflicts that exist or may arise during the life of a fund.

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