SEC Settlement With Corinthian Capital Reflects Continued Scrutiny of Private Equity Firms and Other Fund Managers

By H. Gregory Baker and Scott H. Moss

On May 6, 2019, the SEC announced a settlement with a registered investment adviser, Corinthian Capital Group, LLC ("Corinthian"), along with its CEO and CFO/CCO, which found that Corinthian failed to properly apply offsets against management fees that Corinthian charged to a private equity fund it managed (referred to as CEF 2), improperly took loans from the fund, and improperly charged the fund for certain expenses that were expressly carved out by the fund's Limited Partnership Agreement ("LPA").[1] The settled order also found that Corinthian violated the Custody Rule, that it failed to maintain adequate compliance policies and procedures, and that the CEO failed reasonably to supervise the firm's CFO/CCO.

In re Corinthian Capital Group is an important reminder that the SEC continues to focus on private equity and other firms, and that registered investment advisers must remain vigilant in ensuring that their LPA disclosures concerning management fee offsets; expense allocation; and principal, agency, and affiliate transactions are clear and carefully followed. It is also a reminder that the SEC is willing to hold individuals (in particular, CCOs and other executive officers) accountable when they are closely tied to the misconduct, and of the elevated risk of holding multiple titles (like CCO and CFO).

Background

Corinthian's Failure to Apply Management Fee Offsets

The SEC's settlement with Corinthian found that the firm failed to apply $1.2 million in offsets to the management fee that Corinthian charged to CEF 2, based on Corinthian's improper application of a "deemed contribution" provision in CEF 2's LPA. Under the deemed contribution provision, certain limited partners who were principals of Corinthian could satisfy up to 80% of their capital call obligations for an acquisition without contributing the full amount of the money. For example, in the case of a $1 million capital call, a limited partner could contribute $200,000, with the $800,000 balance being a deemed contribution. Limited partners who did not invoke the deemed contribution provision would be responsible for their entire $1 million capital call, of which $800,000 would be offset against that limited partner's management fee obligation.

Corinthian delayed the implementation of the deemed contribution provision during the capital call associated with CEF 2's first acquisition. However, Corinthian decided to implement the deemed contribution provision for the second acquisition, and retroactively implemented the provision with respect to the first capital call. As a result of the retroactive application, the capital call notices issued to the Corinthian principals for the second acquisition reflected a net credit of $1.9 million resulting from the principals' overpayment for the first capital call. The credits were payable to the CEO and two other principals.

But the SEC's settlement found that the LPA failed to specify whether a deemed contribution could be applied retroactively, and that when it was applied in this case, Corinthian failed to retroactively apply a corresponding management fee offset to collected management fees. Had the management fee offset been retroactively applied at the time the deemed contribution was retroactively applied, CEF 2's obligation to pay management fees and fund the deemed contribution would have been reduced by $1.4 million, and would have reduced the credit owed to the CEO and two principals from $1.9 million to $500,000.

Improper Loans From CEF 2 to Corinthian

The settlement also found that when Corinthian was unable to make a $2.8 million payment on its line of credit from a bank, the firm directed CEF 2 to withhold deemed contribution credits owed to Corinthian's principals that were held by CEF 2, and transferred $1 million of that amount from CEF 2 to Corinthian's bank account. The settlement found, however, that had the deemed

[1] In re Corinthian Capital Group, LLC, Investment Advisers Act Release No. 5229 (May 6, 2019) (settled order finding that Corinthian violated Section 206(2) and Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act"), and Rule 206(4)-2, Rule 206(4)-7 and Rule 206(4)-8 thereunder; that David G. Tahan, the CFO and CCO, caused Corinthian's violations of Section 206(2) and Section 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder; and that Peter B. Van Raakte, the CEO, failed to adequately supervise Tahan).

contribution management fee offset been properly applied, only $500,000 would have been available to Corinthian. Moreover, there was no provision in the CEF 2 LPA or elsewhere authorizing Corinthian to use CEF 2 assets as loans.

Improper Charges for Expenses

CEF 2 was responsible for paying up to $1.5 million in organizational expenses incurred by Corinthian. However, the term "organizational expenses" specifically excluded placement fees, and some placement fees were improperly charged as organizational expenses to CEF 2. Moreover, the settlement found that Corinthian improperly transferred funds from CEF 2 to its account based on prior years' audited financial statements and estimated future charges, but that such practices were improper because the expenses had not actually been incurred.

The discovery of the improper loans from CEF 2 to Corinthian and the improper charging of expenses led Corinthian's auditor to withdraw from its engagement and withdraw prior unqualified audit opinions, and caused Corinthian to violate the Custody Rule for failing to obtain audited financial statements within 120 days from the end of each fiscal year.

Last, by virtue of the conduct described in the settled order, the SEC found that Corinthian lacked adequate compliance policies and procedures, and that the CEO failed to reasonably supervise the CFO/CCO.

Takeaways

In re Corinthian Capital Group reflects the SEC's continued efforts to scrutinize private equity fund advisors to ensure that their management fee offsets; expense allocations; and principal, agency, and affiliate transactions (among other areas) are consistent with their LPA disclosures.[2] Indeed, the SEC's most recent annual report indicates that actions concerning investment advisory issues accounted for 22% of all stand-alone cases filed by the SEC in fiscal year 2018—second only to the 25% of enforcement actions concerning securities offerings.[3] There is no reason to believe that these trends will not continue. Investment advisers to private equity and other funds should remain vigilant in ensuring that their LPA disclosures are clear, and are being closely followed.

Consistent with the SEC's increased focus on personal accountability, it is also noteworthy that the SEC settled with Corinthian's CFO/CCO. The SEC historically has been cautious about holding CCOs accountable, but here the CCO also served as the Chief Financial Officer of Corinthian, and was also responsible for reviewing and interpreting Corinthian's LPA, and transferring funds from the CEF 2 to Corinthian. The SEC likely decided to include him in the settlement based on his dual roles at Corinthian, and based on his high level of involvement in the misconduct.

Please contact H. Gregory Baker, Scott H. Moss, or your regular Lowenstein Sandler contact if you have any questions regarding OCIE or enforcement priorities or how your firm can adapt in consideration of such priorities.

*Disclaimer: Corinthian Capital Group, LLC is a client of Lowenstein Sandler, but our firm did not represent any parties in connection with the matters discussed in this alert.

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[2] See, e.g., Andrew J. Bowden, Director, Office of Compliance Inspections & Examinations ("OCIE"), SEC, "Spreading Sunshine in Private Equity," Address Before the Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014) (noting that in examining private equity firms, the most common discovery of violations of law or material weaknesses in controls has been related to the collection fees and allocation of expenses).
[3] U.S. Securities & Exchange Commission, Division of Enforcement Annual Report 2018 at p. 10, available at https://www.sec.gov/files/enforcement-annual-report-2018.pdf.

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