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Allocation of Expenses

Battle-Tested Best Practices for Private Fund Expense Allocations

Oct. 10, 2014

By Vincent Pitaro, *Hedge Fund Law Report*

Private fund managers face conflicts of interest and regulatory risks when they allocate fees and expenses among themselves, the funds they manage and portfolio companies of those funds. See "All-Star Panel at RCA PracticeEdge Session Analyzes Five Key Regulatory Challenges Facing Hedge Fund Managers," Hedge Fund Law Report, Vol. 7, No. 37 (Oct. 2, 2014). A recent presentation by the American Law Institute, entitled "Best Practices for Allocating and Disclosing Management Fees of Private Equity Fund Advisors," covered the statutory and regulatory regime that governs expense allocations and disclosures, the consequences of failing to comply with that regime, best practices in regard to expense allocations, investor due diligence, and how to respond to discovery of allocation errors or deficiencies in policies and procedures. The speakers were Ellen Kaye Fleishhacker, a Partner at Arnold & Porter LLP, and Matthew Okolita, a Managing Director at CounselWorks LLC.

Fleishhacker said that the SEC has been focusing on fee and expense allocations by private equity (PE) managers. See "Top SEC Officials Discuss Hedge Fund Compliance, Examination and Enforcement Priorities at 2014 Compliance Outreach Program National Seminar (Part Three of Three)," Hedge Fund Law Report, Vol. 7, No. 9 (Mar. 7, 2014). Failure to comply with applicable rules can lead to enforcement actions and investor lawsuits. In her experience, for some investors, the issue of expense allocations is a distraction because such allocations are typically quite small in relation to a fund's assets. For others, even in the case of low dollar amount allocations, the principles governing allocations matter. Thus, some investors are asking for greater disclosure with regard to expense allocation practices. Fleishhacker stressed that the keys to avoiding regulatory and investor problems when allocating fees and expenses are making appropriate disclosures to investors and having an effective compliance program to assure that expenses are allocated in accordance with clearly-defined policies and procedures.

For a comprehensive overview of the regulatory and practical issues concerning allocation of fund and manager expenses, see "How Should Hedge Fund Managers Approach the Allocation of Expenses Among Their Firms and Their Funds? (Part One of Two)," Hedge Fund Law Report, Vol. 6, No. 18 (May 2, 2013); and Part Two. For a comprehensive discussion of the allocation of Form PF expenses in particular, see "How Should Hedge Fund Managers Allocate Form PF Expenses Between Their Hedge Funds and Their Management Entities?," Hedge Fund Law Report, Vol. 5, No. 25 (Jun. 21, 2012).

Regulatory and Statutory Framework

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Fleishhacker said that the SEC generally looks at fee and expense allocations by asking whether, based on a fair reading of a fund's governing documents, a reasonable investor would expect a given expense to be charged to the fund or borne by its manager. She explained that enforcement action relating to the improper allocations of expenses can arise under a number of provisions of the federal securities laws:

- The general antifraud provisions of Section 17(a) of the Securities Act of 1933 and 10(b) of the Securities Exchange Act of 1934 would apply to a fund's general partner and its sponsors.
- A fund's investment adviser is subject to the antifraud provisions of Section 206 of the Investment Advisers Act of 1940 (Advisers Act). Section 206 also imposes a fiduciary duty on investment advisers: An adviser must always act in the best interest of its client and must disclose all material facts to its clients, especially if there is a potential conflict of interest.
- Section 207 of the Advisers Act prohibits the making of false statements in a report to the SEC.
- Advisers Act Rule 206(4)-7 requires registrants to adopt compliance policies reasonably designed to prevent violations of the Advisers Act; poor accounting controls and other compliance failures can lead to incorrect allocations of expenses.
- Rule 206(4)-8 covers fraud by an adviser to a pooled vehicle such as a private fund.

Fleishhacker noted that the February 2014 SEC enforcement action against Clean Energy Capital LLC and one of its founders alleged violations of all of those provisions arising out of improper allocations of expenses between a manager and its funds. See "SEC Order Suggests That Private Fund Operating Expenses Should Be Allocated Based on Line-by-Line Determinations Rather Than an Across-the-Board Percentage Split," Hedge Fund Law Report, Vol. 7, No. 9 (Mar. 7, 2014).

Fleishhacker said that several of those provisions also factored into the recent SEC settlement with investment adviser Lincolnshire Management, Inc. (Lincolnshire). She said that Lincolnshire had integrated the management of two portfolio companies that were owned by separate funds that it advised; those companies shared certain services. Lincolnshire allocated the expenses for those services to each company based on the percentage of revenue such company contributed to the aggregate revenues of both companies. She said that the SEC identified several misallocations. First, one company paid $200,000 over eight years to a retirement plan administrator that provided services to both companies. Second, Lincolnshire failed to allocate properly the salaries of certain employees who worked for both companies. Third, it failed to allocate overhead for a subsidiary of one company to the second company, even though the subsidiary's employees provided services to the second company. Finally, Lincolnshire caused the fund that owned one company to pay bonuses to the employees of the other company, which it did not own. The SEC claimed that Lincolnshire's misallocations of expenses and inadequate policies and procedures constituted deceptive conduct and a breach of fiduciary duty in violation of Advisers Act Section 206 and violated Rule 206(4)-7. For a comprehensive discussion of that settlement, see "Enforcement Action against Private Equity Fund Manager Highlights Five Aspects of the SEC's Thinking on Allocation of Expenses," Hedge Fund Law Report, Vol. 7, No. 36 (Sep. 25, 2014).

Presence Exams

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Fleishhacker said that, through its Presence Exam program for newly-registered private fund advisers, which is expected to end this month, the SEC Office of Compliance Inspections and Examinations (OCIE) has focused on fee allocation practices and the disclosure of those practices. She noted that the SEC's concern about conflicts of interest had led it to focus on fee allocations. She also cited OCIE Director Andrew Bowden's May 6, 2014 speech, in which he discussed what the SEC was learning from presence exams and called attention to problems with allocation practices. OCIE found that over 50% of newly-registered private equity advisers had violated laws or had weak controls, including with regard to fee and expense allocations. In addition, 40-60% had disclosure and policy and procedure weaknesses, which included:

- Hiring an individual who is at first paid by the fund manager but who then becomes a consultant paid by the fund or a portfolio company;
- Having portfolio companies pay for consultants whom investors believe to be employees of the manager;
- Billing for back office functions that used to be part of a manager's overhead;
- Billing a fund for automation that replaces the services of an employee who had been paid by the manager;
- Undisclosed or hidden monitoring, administrative, transaction and other fees (according to an October 7, 2014 article in the Wall Street Journal, Blackstone will no longer collect monitoring fees or will distribute such fees to investors or reduce other fees by the amount of monitoring fees); and
- Mischaracterization of expenses.

She observed that offering documents often contain broad language on expense allocations and significant gray areas as to whether and when expenses can be charged to a fund. Okolita added that, after the presence exam initiative, practitioners are expecting an increase in examinations of private fund advisers and additional scrutiny and skepticism by investors. Consequently, funds will need to provide greater transparency on fee and expense issues.

Consequences of Inadequate Allocation Policies and Procedures

Okolita reiterated that the keys to avoiding violations relating to fee and expense allocations were making appropriate disclosures and having sophisticated policies and procedures to assure proper allocations. He discussed a number of adverse consequences that could result from improper expense allocations or deficient allocation policies and procedures. First, the SEC may become involved as a result of tip from a whistleblower or as result of routine examination. SEC involvement may lead to:

- *Deficiency letter*. Most examinations end in this way. The SEC usually finds some issue or deficiency in an adviser's policies and procedures. The adviser will have an opportunity to address the issues raised in the letter, but there may still be a referral to the Enforcement Division.
- *Enforcement action*. This is a formal investigation commenced by a formal order for investigation that specifies what provisions of law the adviser is alleged to have violated. Enforcement actions are typically handled by an adviser's outside counsel. There may be a

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duty to disclose the enforcement action to investors, or the issue may come up in investor due diligence.
- *Asset freeze*. The SEC may freeze an adviser's assets or stop its business if it believes there is an imminent threat to investor funds or assets.

Other adverse consequences may include:

- *Private rights of action.* In addition to the penalties and other sanctions available to the SEC, there is an implied private right of action for damages. Okolita and Fleishhacker think this is less of a risk to managers even though class actions are indeed possible. See "U.S. District Court Denies Class Certification for Investors in Defunct Hedge Fund Parkcentral Global," Hedge Fund Law Report, Vol. 7, No. 34 (Sep. 11, 2014). They have also seen claims by investors under state securities laws based on misleading offering documents and/or the collection of excess fees and expenses.
- *Redemption rights.* Improper allocations could constitute a violation of a fund's limited partnership agreement, which could give rise to a redemption right or, worse, a claim for rescission of contract and return of fees paid.
- *Referral to Regulators.* Okolita said this was the most common issue, and was especially likely in the event of an investor that is an ERISA fund. It could lead to a cause-based examination and a referral for enforcement action.

Current Allocation and Disclosure Practices

In the speakers' experience, the recent SEC examinations and enforcement actions and the Bowden speech have not changed how managers are handling allocation issues. Fleishhacker said that typically, a fund pays the costs directly associated with operating and managing its investments: Expenses include the traditional 2% management fee; legal, accounting, audit, custody, regulatory, investment, organizational (up to a cap), advisory committee, banking and brokerage expenses; and the cost of winding down the fund. The manager typically pays for its own operations and overhead, including formation, salary/benefits, rent, office equipment and technology, registration, placement agent or finder fees, and excess fund organizational fees. Some managers also pass on a portion of their formation and/or registration costs; they must make appropriate disclosures when they do so. For a closer look at recent allocation practices, see "ACA Compliance Report Facilitates Benchmarking of Private Fund Manager Compliance Practices (Part Two of Two)," Hedge Fund Law Report, Vol. 6, No. 39 (Oct. 11, 2013).

She added that allocations among multiple entities must be equitable. A specific methodology is not typically disclosed in a fund's offering documents. However, it definitely should be included in a fund's compliance manual; and there should be clear written policies and procedures. The methodology should be provided to investors on request. She said that under current market practices, overlapping expenses are usually allocated based on the relative benefit provided by a product or service to a fund and its manager and/or a sister fund or, as in the case of Lincolnshire, based on portfolio company revenues. Fleishhacker noted that there are many gray areas in allocating expenses between managers, funds and portfolio companies in regard to travel, marketing, and regulatory and compliance matters. She recommended having "a lot of clarity about who is paying for what."

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Investor Due Diligence

Fleishhacker reiterated that not all investors believe that fee allocations are a material issue. Those that do may ask a number of questions to fund managers:

- How a manager has handled allocations for past funds;
- How and when a manager will have a function provided by a consultant who is paid by a fund or portfolio company rather than by an employee of the manager;
- Whether consultant fees offset management fees;
- Whether transaction fees offset management fees and, if so, by how much;
- Details on allocations of specific types of expenses;
- Treatment of "luxury" expenses such as travel in private jets or stays in luxury hotels; and
- Expense and travel policies.

An investor's due diligence questionnaire can be used to get this information. Fleishhacker observed that seed investors have much more leverage to obtain such information.

Best Practices for Managers

Okolita said that there is nothing new with regard to disclosures: The key to compliance is to make a full and complete disclosure of allocation policies. This is accomplished through disclosure in a fund's partnership agreement or other governing document, the investor due diligence questionnaire process and ongoing reporting to investors. Okolita added that the concept of materiality is less important in the area of expense allocation policies and procedures: The SEC views allocation of expenses as a fiduciary duty, so the materiality of the amount of an expense is not important.

The Dodd-Frank Act requires companies to implement strong compliance programs and to have a chief compliance officer who is knowledgeable and competent. Okolita said that recent cases suggest that a CCO should also have some background in accounting. He noted that compliance duties used to be split among finance, compliance and legal departments. Now, however, the CCO has the ultimate responsibility to discharge a firm's compliance manual, so the CCO must be knowledgeable about expense allocations at the fund level. Okolita said that managers should adopt written expense policies and reference those policies in the firm's compliance manual. The CCO should be responsible for those policies. He observed that Lincolnshire had a procedure for allocations, but that the SEC wanted to see a detailed *written* procedure. According to Okolita, the key is to "set a good strong policy and show that you have adhered to it."

Okolita said that an adviser's internal audit function may be more effective in finding allocation issues than external auditors. He recommends internal audit of an adviser's fee and expense allocation policies and practices to assure that practice comports with policy. An adviser must also conduct the annual review called for by Advisers Act Rule 206(4)-7 and must be able to show the SEC that the firm is "thorough and thoughtful" on allocation issues. In addition, a manager should conduct other periodic reviews of its expense allocation policies and procedures; they should be tested regularly as part of the firm's compliance program.

Managing Expense Allocation Risk

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Okolita said that a manager should follow SEC guidance and the firm's own risk profile in allocating expenses, not what others in the industry are doing. Moreover, its practices should align with what its governing documents say. If a manager discovers a problem with expense allocations, it should first assess the scope of the problem. It may need to notify investors, which can be done through letters, calls or posting information to data rooms. He said the context and the nature of the problem will affect what disclosure is appropriate. Fleishhacker added that a firm may need to amend past disclosures and regulatory filings. It should also immediately reimburse a fund for any improper charges to the fund. She noted that, because there is limited liquidity in a PE fund, in the "most egregious cases" the only equitable remedy may be to offer redemption rights to investors.

Okolita said that if a manager corrects an identified problem by implementing a new process or procedure, the manager must amend its policies and procedures and compliance manual, and may need to update its governing documents and regulatory filings. A firm must test any new process or policy that it implements. Finally, a firm should consider self-reporting a problem, which may lead to leniency or lighter sanctions. However, he said there is no evidence that self-reporting actually leads to leniency. Fleishhacker added that a manager should maintain documentation of its expense allocation policies and procedures, and any changes to them, so that it can verify compliance to the SEC.

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