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Allocation of Expenses

Eight Bad Excuses Fund Managers Have Raised Trying to Avoid SEC Sanctions for Fee and Expense Allocation Violations and Undisclosed Conflicts of Interest

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Over the last several years, fund managers have tried to explain to the SEC why alleged conflicts of interest or improper fees and expense allocations were not, in fact, violations. These excuses may reflect a temptation for fund managers to explain away these issues, rather than fixing the actual problems. However, by understanding in advance the excuses that the SEC has rejected, managers can avoid this false sense of security if the underlying issues are revealed at any point, up to and including during an SEC examination. For more on SEC examinations, see our two-part series: "What Hedge Fund Managers Need to Know About Getting Through an SEC Examination" (Jun. 16, 2016); and "Fees, Conflicts, Investment Allocations and Other Hot Topics Hedge Fund Managers Should Expect During an SEC Examination" (Jun. 30, 2016).

To help our readers avoid the same faulty logic, this article outlines eight excuses that have failed to persuade the SEC and avert enforcement actions or other sanctions when raised by managers. For more on conflicts of interest, see "Seward & Kissel Private Funds Forum Explains How Managers Can Prevent Conflicts of Interest and Foster an Environment of Compliance to Reduce Whistleblowing and Avoid Insider Trading (Part Two of Two)" (Sep. 29, 2016); and "Former SEC Asset Management Unit Co-Chief Describes the Agency's Focus on Conflicts of Interests and Increased Efforts to Crack Down on Private Fund Managers" (Sep. 15, 2016).

Expense Amounts in Question Were De Minimis Relative to Assets Under Management

At no point in its speeches or enforcement actions against fund managers has the SEC identified a materiality threshold below which it will not target expense allocations. In fact, in multiple recent orders the SEC has specifically cited certain types of expense allocations as violations which the market would consider immaterial.

In its August 2015 order against Guggenheim Partners Investment Management, LLC, the SEC highlighted the manager's policy forbidding employees to accept gifts or entertainment from clients in excess of $250 in value. See "SEC Settlement With Investment Adviser Highlights Perils of Undisclosed Conflicts of Interest" (Aug. 27, 2015). In its examination of the manager, the SEC found that at least 7 employees took at least 44 unreported flights on the private planes of the

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manager's clients, all of which violated this de minimis gift threshold. See "Recommended Actions for Hedge Fund Managers in Light of SEC Enforcement Trends" (Oct. 22, 2015).

A second SEC enforcement action against Clean Energy Capital LLC (Clean Energy) in February 2014 further reinforces this point. In that case, the SEC reviewed a number of "split expenses" identified by the manager to be borne equally by it and its funds. The SEC found that in the aggregate at least $3 million of the manager's expenses were improperly allocated to the funds. However, the SEC's order is notable for its painstaking itemization of seemingly inconsequential expenses contributing to this violation, including group photos, bottled water, holiday cards and business cards. 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" (Mar. 7, 2014).

The SEC's emphasis on seemingly immaterial dollar amounts is counterintuitive given that the SEC gauges materiality when evaluating many other hedge fund compliance efforts (*e.g.*, maintaining books and records). Marc Elovitz, a partner and chair of Schulte Roth & Zabel's investment management regulatory and compliance group, accounts for this difference in approach by the fact that the SEC evaluates improper fees and expenses as related party transactions. This is an important characterization, Elovitz explained, "because it means the investment adviser is making a decision based on what is taken out of its own pocket, resulting in the same level of scrutiny whether it's for $100 or $10 million."

It is important for fund managers to understand the role these seemingly immaterial expense violations play in SEC scrutiny, Elovitz cautioned. A $100 overcharge will not be the sole basis for an exam to be escalated to the SEC Enforcement Division, he explained, but the SEC will not disregard these foot faults just because of their low dollar amounts if enough of them add up. See "SEC's Rozenblit and Law Firm Partners Explain the SEC's Enforcement Priorities and Offer Tips on How Hedge Fund and Private Equity Managers Can Avoid Enforcement Actions (Part Three of Four)" (Jan. 15, 2015).

Offering and Governing Documents Were Drafted – or the Violations Occurred – Prior to the Manager's SEC Registration

The above logic has been soundly rejected by the SEC over the years. Andrew Ceresney, Director of the SEC's Division of Enforcement,explicitly refuted this argument on behalf of the SEC in a May 2016 speech. Ceresney stated that although registration was not typically required until after the Dodd-Frank Act was enacted, private fund managers have always been investment advisers and thus subject to certain provisions of the Investment Advisers Act of 1940 (Advisers Act). "All investment advisers, whether registered or not, are fiduciaries and are subject to the Advisers Act antifraud provisions," he explained. See "SEC Enforcement Director Highlights Increased Focus on Undisclosed Private Equity Fees and Expenses" (May 19, 2016).

The SEC has also implicitly rejected this argument in a number of enforcement actions. For example, in its November 2015 order against Fenway Partners, LLC, the SEC sanctioned a manager for violations that occurred prior to its registration as an investment adviser on March 30, 2012. See "Full Disclosure of Portfolio Company Fee and Payment Arrangements May Reduce Risk of Conflicts and Enforcement Action" (Nov. 12, 2015). Additionally, the SEC went as far back as 2008 in tracking the expense allocation violations in Clean Energy, which predates the enactment of the Dodd-Frank Act in July 2010.

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Manager Relied on Advice From – or Otherwise Had Its Conduct Blessed by – Outside Legal Counsel, Auditors, Administrators, Etc.

In its April 2015 order against Alpha Titans, LLC and affiliates, the SEC specifically addressed a scenario where a registered auditor issued a clean audit opinion with respect to improperly categorized expenses in a fund's financial statements. Rather than permitting the manager to hide behind the auditor's clean audit, the SEC sanctioned Alpha Titans for the improper categorizations of expenses. Additionally, in a parallel civil enforcement proceeding, the SEC also sanctioned Alpha Titan's auditor for willfully overlooking these improprieties in issuing its audit opinion. See "Inadequate Disclosure of Expense Allocations May Carry Unintended Consequences" (May 14, 2015).

In his speech, Ceresney further reinforced the idea that a fund manager "cannot escape liability simply by pointing to the actions of counsel." He did concede, however, that the SEC will evaluate the appropriateness of an enforcement action and potential sanctions against managers where this scenario exists, assuming the manager waives its attorney-client privilege and discloses the advice to the SEC.

The Manager Did Not Benefit From the Improper Allocation

Lincolnshire Management, Inc. (Lincolnshire) operated two funds that owned separate portfolio companies. The manager, however, treated the funds as a single entity due to their complementary operations and resulting synergies.

In its September 2014 order against Lincolnshire, the SEC ultimately found that the manager improperly allocated expenses between those funds based on complications from their treatment of the entities. While the investors in the respective funds were harmed by paying misallocated fees, at no point did the SEC identify any benefit to the manager from this scenario. See "Enforcement Action Against Private Equity Fund Manager Highlights Five Aspects of the SEC's Thinking on Allocation of Expenses" (Sep. 25, 2014).

The Lincolnshire action represents a situation where a manager was sanctioned without benefiting from the violation in question. This excuse is further weakened by the fact that the SEC is willing to impose sanctions even when a manager has voluntarily remedied a violation – including by disgorging ill-gotten gains.

The Manager Had No Fraudulent Intent

This excuse is similar to the immediately preceding one, but it also captures the added wrinkle of mistakes by the manager which lead to expense allocation violations. In her February 2015 "Conflicts, Conflicts Everywhere" speech, Julie M. Riewe, then-Co-Chief of the Asset Management Unit (AMU) of the SEC's Enforcement Division, unequivocally asserted that there is "no 'well-meaning or good-faith adviser' exception for an adviser that legitimately believes it is putting its clients' interests first notwithstanding any conflicts." See "Conflicts Remain an Overarching Concern for the SEC's Asset Management Unit" (Mar. 12, 2015).

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While Riewe's comment occurred in the context of conflicts of interest generally, the assertion is no less applicable to expense allocation violations. In fact, the SEC's order in Lincolnshire specifically drew attention to the fact that Section 206(2) of the Advisers Act does not require proof of scienter, supporting the notion that the SEC even targets "non-fraud-based" breaches of fiduciary duty.

This is further reinforced by the SEC's imposition of sanctions on managers who voluntary disclose improper expense allocations to the SEC and remedy them complete – denoting a lack of fraudulent intent for the underlying the actions.

Investors Were Not Harmed by the Conflict of Interest

Riewe addressed this notion specifically in her speech when she explained that there is "no 'potential conflict' exception for an adviser that did not act upon the conflict to enrich itself at the expense of its clients." This assertion is rooted in the U.S. Supreme Court's ruling in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), which held that the mere existence of conflicts of interest presents a "potential for abuse, which 'operates as a fraud or deceit' within the meaning of the [Advisers] Act when relevant information is suppressed. The [Advisers Act] was 'directed not only at dishonor, but also at conduct that tempts dishonor.'" (citation omitted).

This stance was manifested in the SEC's March 2015 action against Joseph Stilwell and Stilwell Value LLC (Stilwell), where the founder of the manager personally guaranteed a loan from one fund to a second fund. The second fund ended up defaulting on the loan when it was unable to liquidate an advantageous equity position it held in a public company.

Because the founder in Stilwell controlled and owned 99 percent of the general partner of the lending fund, he sat on both sides of the transaction and refused to call the loan or force the exercise of his personal guarantee. The manager and its founder were each sanctioned for this series of actions, despite the fact that every loan was paid in full with interest – resulting in no actual harm to any investor.

For more on Stilwell, see "SEC Settlement Emphasizes the Importance – and Limits – of Fund and Transaction Disclosure" (Apr. 2, 2015); and "SEC Continues Pre-Action Probe of Stilwell Inter-Fund Loans" (Aug. 28, 2014).

Investors Benefited From the Conflict of Interest

This certainly stands as a more compelling argument than the previous one, although the SEC has still found it to be inadequate when evaluating manager conduct.

In his speech, Ceresney acknowledged investor benefit as a factor to consider when assessing remedies, but he noted that it does not eliminate the manager's potential liability. "As a fiduciary," he explained, "an investment adviser is required to disclose all material conflicts of interest so that the client can evaluate the conflict for itself."

Therefore, even if investors ultimately benefit from the conflict of interest, it is important that they be afforded an opportunity to decide for themselves if they would like to receive that benefit in the first place.

The Violations Were (Eventually) Disclosed to Investors

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A hallmark of every good piece of advice to fund managers about expense allocations and conflicts of interest is that it is best to disclose them fully and thoroughly to investors. See "Flawed Disclosures to Avoid – and Policies and Procedures to Adopt – for Managers to Reduce Risk of SEC Scrutiny of Fee and Expense Practices (Part Two of Three)" (Sep. 8, 2016).

The effectiveness of this disclosure is driven predominantly by its timing. If the disclosure is made prior to the violation – particularly at the time the fund is launched or prior to investors joining the fund – then investors' decisions to proceed with investing in the fund constitute implicit consent to the underlying actions.

Conversely, if a conflict of interest or improper expense allocation is only disclosed to investors after it occurs, then that alone is inadequate to remedy the issue. See "How Fund Managers Can Prevent or Remedy Improper Fee and Expense Allocations (Part Three of Three)" (Sep. 15, 2016).

This issue was also highlighted by the SEC in its action against Stilwell, where it specifically deemed a manager's disclosure of inter-fund loans to be inadequate when it first occurred only eight months after the loans were made.

Post-violation disclosure is only effective if it is coupled with investors' consent to the action in question.

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