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Another Lesson For Private Funds On Expense Allocation

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The U.S. Securities and Exchange Commission has settled an administrative proceeding against a hedge fund manager, its 95 percent owner and chief executive officer, and its general counsel (who also served as chief operating officer), arising out of allegations that the fund manager improperly used fund assets to pay for adviser-related operating expenses.[1] This proceeding, In re Alpha Titans LLC, is the latest in a series of actions by the SEC against private fund managers in connection with alleged improper shifting of management company expenses to private fund clients, and follows proceedings against Clean Energy Capital and Lincolnshire Management Inc. during 2014.[2]

The Alpha Titans case reinforces the increased scrutiny by the SEC on management company expense allocations, and the SEC's concerns regarding other abuses that may arise from expense allocations, including the mischaracterization of expenses and unfair allocation of expenses. These themes were emphasized by Andrew J. Bowden, then-director of the Office of Compliance Inspections and Examinations, in his May 2014 "sunshine" speech at the Private Fund Compliance Forum 2014,[3] and were echoed more recently by Julie M. Riewe, co-chief of the Asset Management Unit, Division of Enforcement, in her speech titled "Conflicts, Conflicts Everywhere" at the IA Compliance Conference on Feb. 26, 2015,[4] and by Marc Wyatt, acting director of the OCIE, in his May 13, 2015, speech.[5] Reports also speculate that some larger private equity firms may also be impacted by other themes raised in these speeches, such as the allocation of expenses between funds and co-investors.[6]

In Alpha Titans, the SEC alleged that the investment manager used fund assets to pay adviser-related operating expenses, including employees' salaries and health benefits, rent, parking, utilities, computer equipment, technology services and other operational costs. The SEC alleged that Alpha Titans breached its fiduciary duty by using "assets of fund clients to pay its expenses without *clear* authorization in the funds' operating documents" (emphasis added). A distinction appears to be drawn by the SEC through its use of the word "clear" with respect to the authorization, and it appears to reflect a growing preference for investment managers to use specific, detailed language in discussing and disclosing conflicts of interest in order to permit investors to understand both the potential scope and magnitude of such conflicts.

The SEC also alleged that Alpha Titans distributed materially misleading financial statements for the funds that inadequately and incorrectly described the total amount of Alpha Titans' expenses paid by the funds and the related party relationships, and that the failure to provide financial statements compliant with U.S. generally accepted accounting principals (GAAP) resulted in a violation of the custody rule under the Investment Advisers Act of 1940.

Lastly, the SEC identified certain deficiencies in Alpha Titans' Form ADV by virtue of it is failure to disclose the absorption of certain expenses by the funds as compensation received by the adviser. This failure to provide GAAP-compliant[7] financial statements resulted in a violation of the custody rule under the Advisers Act.[8]

Clear, Detailed Disclosure Is Required

Alpha Titans reflects increased efforts by the SEC to confirm the proper authorization of expenses (and other activities, for that matter) in a fund's operating documents as well as the SEC's desire to see greater detail, and more prominent disclosure, regarding the type and scope of expenses to be borne by fund clients. In Alpha Titans, the operating and limited partnership agreements of the underlying feeder funds provided that "[t]he Fund shall bear all the costs and expenses of its operation," but did not contain specific language stating that the feeder funds would bear the costs of the investment manager's operational and administrative expenses.

In determining the scope of such costs and expenses that might be borne in connection with the fund's operations, the SEC ostensibly was willing to consider the disclosure provided in the funds' private placement memoranda and potentially incorporate such disclosure into the authorizations provided in the operating agreements to the extent they properly augmented the agreement. The funds' private placement memoranda did attempt to disclose that the funds would bear certain adviser-related expenses as the offering memoranda dated August 2009 and later contained the following disclosure:

The Partnership bears all of the expenses incurred by it or by others on its behalf or for its benefit, including ordinary operational and administrative expenses, expenses incurred in connection with the continuing offering of the Interests, expenses incurred in direct or indirect investment activities, financing and transaction costs, interest expenses on funds borrowed on its behalf, and extraordinary expenses, if any. For example, *the Partnership bears a pro rata portion of certain operational, administrative and other expenses of the General Partner* that are incurred for the benefit of the Partnership. [emphasis added]

Although the private placement memoranda generally disclose the absorption of certain types of adviser-related expenses by the feeder funds, the SEC appears to take issue with the lack of specific disclosure regarding the type and scope of adviser-related expenses that the funds would pay. The absence of such disclosures ostensibly was compounded by the presence of more specific disclosure in prior versions of the offering memoranda. This appears to be a key takeaway, and consistent with Riewe's directions in February that investment managers "ensure that all conflicts are disclosed and disclosed in a manner that allows clients or investors to understand the conflict, its magnitude, and the particular risk it presents."

The best protection continues to be robust disclosure to investors regarding any fees and expenses that are directly or indirectly paid by a fund. Fund sponsors should review all of their relevant disclosure documents, including private placement memoranda, limited partnership and other operating agreements and Forms ADV to ensure that they disclose such conflicts with sufficient precision, and that

disclosures in all such documents are consistent. While seemingly an obvious recommendation, fund sponsors also should review their underlying constituent documents to ensure that they are properly authorized to pass through any and all applicable adviser-related expenses; they also should consider the extent to which they have provided sufficient detail regarding fund-related operating expenses. Lastly, with respect to disclosure of related-party transactions, fund sponsors should discuss with fund auditors whether related-party transactions, if any, are properly disclosed in fund financial statements.

Recent reports also suggest increased interest in other areas identified by Bowden and Riewe. These include operating partner and other potential sources of "hidden fee" conflicts where advisers are earning fees from multiple sources relating to the management of client accounts.

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[1] In re Alpha Titans LLC et al., SEC Release No. 34-74828 (Apr. 29, 2015), available at http://www.sec.gov/litigation/admin/2015/34-74828.pdf.

[2] See, e.g., In re Lincolnshire Management Inc., SEC Release No. IA-3927 (Sept. 22, 2014), available at http://www.sec.gov/litigation/admin/2014/ia-3927.pdf; In re Clean Energy Capital LLC et al., SEC Release No. 33-9667 (Oct. 17, 2014), available at http://www.sec.gov/litigation/admin/2014/33-9667.pdf

[3] Andrew J. Bowden, director, Office of Compliance Inspections and Examinations, SEC, Remarks at Private Equity International Private Fund Compliance Forum 2014: Spreading Sunshine in Private Equity (May 6, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370541735361. Bowden noted that during exams the SEC had "seen advisers bill their funds separately for various back-office functions that have traditionally been included as a service provided in exchange for the management fee, including compliance, legal, and accounting — without proper disclosure that these costs are being shifted to investors."

[4] Julie M. Riewe, co-chief, Asset Management Unit, Division of Enforcement, SEC, Remarks to the IA Watch 17th Annual IA Compliance Conference: Conflicts, Conflicts Everywhere (Feb. 26, 2015), available at http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html.

[5] Mark Wyatt, acting director, OCIE, SEC, Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), available at http://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[6] Mark Maremont, KKR Refunds Some Fees to Investors, Wall Street Journal, Jan. 21, 2015, http://www.wsj.com/articles/kkr-refunds-some-fees-to-investors-1421882828.

[7] Among other things, FASB ASC 850-10-50 requires financial statements to include disclosures of certain material related-party transactions, which disclosures must include the nature of the relationship, a description of the transactions, and the dollar amounts of the transactions. According to

the SEC, for each of the relevant years, the financial statements omitted hundreds of thousands of dollars of related-party transactions pertaining to the expenses borne by the fund (directly or through the subsidiary special-purpose vehicles).

[8] The SEC noted that the fund manager was using the “audit option” in Rule 206(4)-2(b)(4) under the Advisers Act, which, among other things, requires an adviser to annually distribute audited financial statements that are prepared in accordance with U.S. GAAP. The SEC also separately settled an administrative proceeding against the audit partner who approved the unqualified opinions for the fund financial statements. In re Simon Lesser, CPA, CA, SEC Release No. 34-74827 (Apr. 29, 2015), available at http://www.sec.gov/litigation/admin/2015/34-74827.pdf.

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