Simpson Thacher

Memorandum

Recent SEC Enforcement Actions Reflect a Continuing Focus on Expense Allocation and Conflicts of Interest

December 19, 2018

The U.S. Securities and Exchange Commission ("SEC") recently settled three enforcement actions against investment advisers alleging misallocation of expenses and failure to disclose conflicts of interest. While the actions do not break new ground, they reflect the SEC's continuing focus on these areas and serve to highlight some of the types of expense allocation practices and undisclosed conflicts of interest that continue to draw regulatory scrutiny. Below is a summary of each of these three enforcement actions, as well as some key takeaways for investment advisers.

Background

In 2012, the SEC's National Exam Program commenced its "Presence Exam Initiative" designed to assess the compliance issues and risks presented by the business model of the private equity industry.[1] In 2014, the staff of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), based on the results of those examinations, expressed concerns over the fee and expense practices of advisers to private equity funds and the related conflicts of interest these advisers face.[2] The SEC has since brought a series of enforcement actions against investment advisers concerning a variety of fee and expense practices, including, for example, the acceleration of monitoring fees, the receipt of consulting fees from portfolio companies, and the allocation of broken-deal expenses and adviser-related operating expenses to funds. In addition, in April 2018, OCIE issued a National Exam Program Risk Alert that outlined common examination deficiencies observed by OCIE staff relating to advisory fees and expenses, which included certain deficiencies involving the allocation of expenses to funds.[3]

---

[1] *See e.g., Spreading Sunshine in Private Equity*, Andrew J. Bowden (May 6, 2014), available at https://www.sec.gov/news/speech/2014--spch05062014ab.html.

[2] *See id.*

[3] For a fuller discussion of OCIE's "Risk Alert," please see our April 2018 Memorandum entitled, *SEC Risk Alert Highlighting Common Deficiencies Relating to Fees and Expenses*, available at http://www.stblaw.com/docs/default-source/memos/firmmemo_04_19_18.pdf.

Key Takeaways

The three enforcement actions summarized below reflect the SEC's continued scrutiny of expenses that advisers charge to the funds they manage. At issue in each of these settlements was the allocation of compensation-related expenses for an advisory firm's own employees to the firm's advisory clients. These actions indicate that allocating these types of expenses to advisory clients continues to draw robust regulatory scrutiny, both in the examination and investigative setting. Accordingly, before allocating compensation-related expenses of their employees to a fund they manage, advisers should closely consider whether the fund's governing documents, pre-commitment disclosure and applicable law unambiguously provide for such an allocation.

In addition, the three enforcement actions serve as a reminder that, even when an investment adviser is permitted to allocate a portion of the compensation of the adviser's own employees to a fund it manages, the adviser should adopt a clear written allocation methodology based on how much time the employees spent on various tasks and should periodically assess compliance with the underlying methodology. In light of these settlements, advisory firms that have such an allocation practice should evaluate whether their existing policies and procedures adequately document the methodology used to determine what percentage of an employee's compensation will be allocated to funds (and whether such methodology is being strictly adhered to).

Lastly, one of these enforcement actions highlights that the SEC remains focused on conflicts of interest faced by advisers to private equity funds. The adviser in this enforcement action managed private equity funds that paid for consulting services from one service provider in which the adviser's principal made a personal investment and from another service provider whose principal received a loan from the adviser's principal. The SEC found that these arrangements posed actual or potential conflicts of interest that should have been disclosed. Investment advisers, in response to this settlement, should assess whether they have entered into similar arrangements with service providers and, if so, whether such arrangements should be disclosed to fund advisory committees or investors.

In the Matter of Fifth Street Management, LLC[4]

On December 3, 2018, the SEC announced a settlement with Fifth Street Management, LLC ("FSM") relating to, among other things,[5] allegations concerning FSM's allocation of overhead expenses and employee compensation to its former clients that elected to be regulated as business development companies under the Investment Company Act of 1940 ("BDCs").

[4] *In the Matter of Fifth Street Management, LLC*, Release No. IA-5070 (Dec. 3, 2018), available at https://www.sec.gov/litigation/admin/2018/33-10581.pdf.

[5] The SEC also alleged FSM committed certain violations relating to the valuations of its BDC clients' portfolio companies and to FSM's policies and procedures concerning the misuse of material non-public information. These SEC allegations are outside the scope of this Memorandum.

Allocation of Expenses to BDC Clients

According to the SEC's order, FSM's investment advisory agreements with its BDC clients provided that FSM was responsible for paying "compensation and routine overhead expenses" of its personnel. The SEC alleged that FSM and the BDCs used the same office space, and numerous employees performed work for both FSM and the BDCs. The order stated that even though FSM allocated compensation expenses for only 8 or 9 of its 52 to 75 employees to the BDCs, FSM allocated essentially all of its rent and other overhead expenses associated with its employees to the BDCs. According to the SEC, this over-allocation of rent and other overhead expenses to the BDCs amounted to $1,208,510.

In addition, the order alleged that the BDCs were allocated compensation expenses for two FSM employees who helped prepare the Form S-1 for an FSM affiliate's 2014 initial public offering ("IPO"). Because the affiliate's IPO was unrelated to FSM's advisory work for the BDCs, the SEC found that the allocation of the compensation expenses for these two FSM employees (which totaled $118,895) was improper.

The order stated that FSM failed to disclose these payments by its BDC clients in its Form ADV and failed to implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (the "Advisers Act") concerning expense allocation during the time in question.

Violations

The SEC alleged that FSM's misallocation of expenses to the BDCs violated the Advisers Act anti-fraud provisions (specifically, Sections 206(2) and 206(4), as well as Rule 206(4)-8), Rule 206(4)-7, the SEC's compliance program rule, and Section 207 of the Advisers Act, which concerns untrue statements made to the SEC. FSM agreed to pay disgorgement of $1,999,115.86, prejudgment interest of $334,545.65, and a civil money penalty in the amount of $1,650,000 to settle the SEC's allegations.[6]

In the Matter of Yucaipa Master Manager, LLC[7]

On December 13, 2018, the SEC announced a settlement with Yucaipa Master Manager, LLC ("Yucaipa"), a registered investment adviser that provides advisory services to certain private equity funds (the "Funds") as well as certain personal investments of Yucaipa's principal (the "Principal"). The SEC alleged that Yucaipa failed to disclose (i) the allocation of certain in-house employee costs to the Funds and (ii) arrangements with service providers that resulted in expense allocation decisions that posed conflicts of interest.

---

[6] These amounts include amounts that relate to FSM's settlement of certain allegations that are beyond the scope of this Memorandum.

[7] *In the Matter of Yucaipa Master Manager, LLC*, Release No. IA-5074 (Dec. 13, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5074.pdf.

Allocation of In-House Employee Costs to the Funds

The SEC alleged that from 2010 to 2015, Yucaipa had the Funds pay $570,198, which represented a portion of the costs of two Yucaipa employees: Yucaipa's in-house tax partner and in-house tax manager, an independent contractor from 2013 to 2015. Both the tax manager and the tax partner allegedly assisted in the preparation of the Funds' tax returns, as well as the tax returns for Yucaipa, its affiliates, and some of the Principal's personal investments.

The SEC's order stated that although the LPAs for all of the Funds provided that the Funds would bear the costs for the "preparation of the Partnership's financial statements, tax returns and schedules K-1," the LPAs further provided that Yucaipa would bear "the costs and expenses incurred by the Manager in providing for its or the General Partner's normal operating overhead, including salaries, other compensation and benefits of the Manager's employees." The SEC alleged that Yucaipa failed to disclose that it was charging the Funds a portion of the costs of its employees who were assisting in the preparation of the Funds' tax returns. According to the order, Yucaipa also failed to adequately disclose how it allocated the costs of its in-house tax personnel across the Funds, Yucaipa, and Yucaipa's affiliates to the Funds' Limited Partner Advisory Boards or investors (the Fund LPAs required the General Partner or Manager to "consult with, and propose an appropriate course of action to the Advisory Board with respect to" each "material conflict of interest. . . of which the General Partner or Manager . . . is actually aware").

Conflicts Raised by Arrangements with Service Providers

Consulting Firm A: The SEC order stated that an investment consulting firm ("Consulting Firm A") advised on specific investments held by the Funds and provided general deal sourcing services to Yucaipa. In exchange, Consulting Firm A was to receive quarterly payments for operating expenses, according to the order. In certain instances, the SEC alleged that one of the Funds was allocated all of the operating expenses Consulting Firm A incurred during a time when Consulting Firm A was providing services to both the Fund and Yucaipa. In another instance, according to the order, Yucaipa used payments a Fund owed to Consulting Firm A to pay off a loan the Principal made to Consulting Firm A's principal. The SEC found that these undisclosed conflicted arrangements resulted in the misallocation of a portion of Consulting Firm A's fees.

Consulting Firm B: The SEC order stated that Yucaipa engaged a talent management and marketing company ("Consulting Firm B") to provide consulting services to one Fund and subsequently to that Fund's portfolio company. Consulting Firm B was paid consulting fees by the Fund, according to the order. During this period, the SEC alleged that Consulting Firm B was also providing services to the Principal's personal investments and that the Principal made a personal investment in Consulting Firm B. The SEC found these undisclosed conflicted arrangements resulted in the misallocation of Consulting Firm B's fees, the failure to credit funds the Principal received from Consulting Firm B to the Fund, and the failure to offset fees received by Consulting Firm B against Yucaipa's advisory fee after the Principal made an investment in Consulting Firm B (pursuant to the Fund LPA's advisory fee offset provision).

Compliance Policies and Procedures

According to the SEC's order, the nature of Yucaipa's business as a private equity fund adviser involves (i) the use of common service providers by Yucaipa, the Funds, the Funds' investments, and the Principal's personal investments and (ii) the allocation of fees, expenses, and payments among Yucaipa, the Funds, the Funds' investments, and the Principal's personal investments. The SEC found that despite the potential risks surrounding the use of common service providers as well as the allocation of related expenses, Yucaipa failed to adopt written policies and procedures reasonably designed to prevent conflicts of interest arising from the allocation of these expenses and payments.

Violations

The SEC alleged that Yucaipa's conduct violated the Advisers Act anti-fraud provisions (specifically, Sections 206(2) and 206(4), as well as Rule 206(4)-8) and Rule 206(4)-7, the SEC's compliance program rule. Yucaipa agreed to pay disgorgement of $1,863,242, prejudgment interest of $71,070, and a civil money penalty in the amount of $1,000,000 to settle the SEC's allegations.[8] Yucaipa also agreed, as a condition of the settlement, to retain at its own expense an independent compliance consultant to, among other things, conduct a comprehensive review of Yucaipa's policies and procedures to identify any needed improvements and to subsequently conduct an annual review to assess whether Yucaipa is complying with its revised policies and procedures.

In the Matter of NB Alternatives Advisers LLC[9]

On December 17, 2018, the SEC announced a settlement with NB Alternatives Advisers LLC ("NBAA"), a registered investment adviser that advises certain private equity funds, concerning the manner in which NBAA allocated compensation-related expenses to three funds it advised.

Background

According to the order, from 2011 to 2016, NBAA and its affiliates ("Neuberger") sponsored and managed three private equity funds, known as the "Dyal Funds." The order stated that the primary investment objective of each Dyal Fund was to acquire minority stakes in alternative investment management companies (the "Dyal Portfolio Companies").

---

8 Note that Yucaipa voluntarily reimbursed the Funds a total of $940,244 for expenses allegedly misallocated to the Funds.

9 *In the Matter of NB Alternatives Advisers LLC*, Release No. IA-84838 (Dec. 17, 2018), available at https://www.sec.gov/litigation/admin/2018/34-84838.pdf.

The order stated that, in 2011, Neuberger established an unincorporated business unit referred to as Dyal Capital Partners ("DCP") and the general partners of the Dyal Funds delegated the day-to-day management of the funds to DCP. According to the SEC, DCP had a group of employees who provided advice and support, including client development, talent management, operational advisory services and sourcing potential new investors, to the Dyal Portfolio Companies (the "Business Services Platform" or "BSP"). The SEC stated that this group of employees, the BSP, was established to increase Dyal Fund returns by helping the Dyal Portfolio Companies attract new capital, launch new products and optimize their operations.

Allocation of Compensation Expenses

According to the order, the limited partnership agreement ("LPA") for each Dyal Fund provided that each of NBAA and the fund's general partner "shall pay the compensation costs of its investment professionals, rent and other overhead expenses of" the fund's investment adviser and general partner. The order further stated that each Dyal Fund LPA also provided that the fund would bear "the incurred fees and expenses (either actual or allocated from Neuberger Berman, or any of its Affiliates) payable relating to the utilization of the Business Services Platform in an amount not to exceed 50 basis points per annum of aggregate Commitments. . ." (the "BSP Expense Allocation").

The order states that from 2012 to 2016, certain BSP employees spent a percentage of their time on tasks that assisted the investment team, such as raising capital for the Dyal Funds, as well as identifying and meeting with companies in which the Dyal Funds might seek to invest. Although some of these tasks may have incrementally benefitted the Dyal Portfolio Companies, the tasks, in the SEC's view, did not involve providing services, support or advice to the Dyal Portfolio Companies. Accordingly, the SEC found the compensation BSP employees received for the time they spent on such tasks was not an "expense[]. . . payable relating to the utilization of the [BSP]." Instead, according to the SEC, their compensation for the time they spent on such tasks was a general compensation expense of the Dyal Funds' advisers, which should have been borne by such advisers pursuant to Dyal Funds' LPAs. However, the SEC alleged that the BSP employee compensation expenses that NBAA allocated to the Dyal Funds during this period were not adjusted to exclude the percentage of BSP employees' time that was not spent on providing advice or support to the Dyal Portfolio Companies.

According to the order, of the $28.7 million in expense paid by the Dyal Funds to BSP employees from 2012 through 2016, approximately $2 million, or 7%, was paid for time spent on non-BSP-related tasks. The SEC found that the allocation of this amount to the Dyal Funds was inconsistent with the disclosures in the funds' LPAs, and that NBAA did not disclose to the Dyal Funds' advisory committees or investors that, during this period, certain BSP employees were spending a percentage of their time on tasks not related to the BSP.

Compliance Policies and Procedures

The order stated that the Dyal Funds, pursuant to their LPAs, were responsible for expenses relating to the utilization of the BSP, while NBAA and its affiliates were responsible for all other compensation expenses. The SEC found that despite this expense allocation policy, NBAA did not adopt or implement any written policies or procedures reasonably designed to prevent the misallocation of compensation-related expenses.

Violations

The SEC alleged that NBAA's conduct violated the Advisers Act anti-fraud provisions (specifically, Sections 206(2) and 206(4), as well as Rule 206(4)-8) and Rule 206(4)-7, the SEC's compliance program rule. NBAA agreed to pay disgorgement of $2,073,988, prejudgment interest of $284,620, and a civil money penalty in the amount of $375,000 to settle the SEC's allegations.

Conclusion

These three enforcement actions highlight that the SEC remains focused on investment adviser expense allocation practices and conflicts of interest. In light of these settlements, advisory firms should assess whether any enhancements should be made to their policies, procedures and practices pertaining to expense allocation and conflicts of interest.

For further information, please contact one of the following members of the Firm.

NEW YORK CITY

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Michael W. Wolitzer
+1-212-455-7440
mwolitzer@stblaw.com

Allison Scher Bernbach
+1-212-455-3833
allison.bernbach@stblaw.com

Manny M. Halberstam
+1-212-455-2388
manny.halberstam@stblaw.com

WASHINGTON, D.C.

David W. Blass
+1-202-636-5863
david.blass@stblaw.com

Ryan Brizek
+1-202-636-5806
ryan.brizek@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000