

Private Equity Adviser Settles with SEC for Misallocation of Internal Expenses Relating to “Third-Party Tasks”

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The SEC issued an order imposing sanctions against private equity adviser Rialto Capital Management, LLC (“Rialto”) for violations of the Advisors Act relating to expense allocation. The [settlement](#) addressed Rialto’s allocation of expenses for certain “third-party tasks” performed by in-house employees, which was allowed under the relevant fund documents with consent of the limited partner advisory committee (LPAC). Yet the SEC took issue with the practice of fully allocating certain expenses to the funds rather than proportionately to co-investors, as well as the manner in which the expenses were disclosed to the LPAC for approval.

Rialto is a registered investment advisor to private equity funds as well as co-investment vehicles and separate accounts. The SEC focused on Rialto’s allocation of certain costs and expenses relating to its performance of “third-party tasks” for two real estate private equity funds. The relevant fund limited partnership agreements (LPAs) allowed a portion of the costs that Rialto employees spent on third party tasks (*i.e.* asset-level due diligence, accounting, valuation, etc.) to be reimbursed by the funds with LPAC consent. However, the SEC found that Rialto misallocated third party expenses that should have been allocated to related co-investment vehicles that Rialto also managed (although the order is silent as to whether the co-investment vehicles has similar expense-shifting provisions). As a result, the SEC alleged the funds were charged approximately \$3 million more than their pro rata share of costs and expenses for third party tasks.

Furthermore, the SEC found that Rialto failed to adequately disclose certain information regarding the third party task expenses to the funds' LPACs when it submitted them for approval. First, while Rialto typically represented that it "[was] able to obtain information" supporting that the cost and expenses related to the performance of third party tasks were "at or below market rates," Rialto last conducted a market rate analysis in 2012. The SEC alleged that Rialto improperly failed to inform the advisory committee that it did not obtain any updated market rate information to support its claim for the 2013 to 2017 time frame. Second, Rialto did not accurately disclose that its cost allocation methodology, which added a percentage "overhead factor" to the total cost for each employee, had increased that percentage from 11% to 25% for 2013 through 2017.

The SEC also found that Rialto failed to adopt and implement written policies and procedures reasonably designed to ensure that costs and expenses related to third party tasks were calculated, allocated, and disclosed properly. The order is silent as to how the Rialto's policies and procedures were deficient.

The order recognized that Rialto promptly remediated these issues by reimbursing the funds for amounts overcharged for costs and expenses, which factored into the settlement. Rialto agreed to cease and desist from any future violations of Sections 206(2) and 206(4) of the Advisors Act and Rules 206(4)-7 and 206(4)-8 thereunder and to pay a \$350,000 civil money penalty.

SEC enforcement has been increasingly focused on expense allocation issues in the private equity space for years. When developing and implementing expense allocations, accurate disclosures to LPs (whether in the LPA or to an advisory committee) and strict compliance with LPA provisions are crucial.

We have added this order to our database tracking SEC enforcement actions involving private equity advisers, available [here](#).

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- **Joshua M. Newville**
Partner