

Client Update

Expense Allocation: The SEC Brings Down the Hammer

WASHINGTON, D.C.

Kenneth J. Berman
kjberman@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

Phil V. Giglio
pvgiglio@debevoise.com

NEW YORK

Erica Berthou
eberthou@debevoise.com

Michael P. Harrell
mpharrell@debevoise.com

Jordan C. Murray
jcmurray@debevoise.com

Jaime D. Schechter
jdschechter@debevoise.com

LONDON

Geoffrey Kittredge
gkittredge@debevoise.com

A recently settled enforcement action demonstrates the Securities and Exchange Commission's (the "SEC") intense focus on the methodologies that private equity fund sponsors use in allocating expenses, both between private equity sponsors and the funds they manage, as well as among commonly managed private funds.¹

A private fund manager (the "Manager") was charged with violating the anti-fraud provisions of the Investment Advisers Act of 1940 (the "Advisers Act") as well as Advisers Act Rule 206(4)-7 (the "Compliance Rule") for, in effect, improperly allocating expenses between two private fund clients and failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act with respect to two "integrated" portfolio companies of those funds.²

The case serves as an important reminder to private equity fund sponsors to adopt expense allocation policies and to take steps to ensure that expenses are allocated in accordance with those policies. This is true even where, as in this case, the expenses arise from services that are provided by a third party directly to fund portfolio companies.

¹ See, [Adviser Beware: Lessons Learned From Recent SEC Examinations and Enforcement Actions](#), Private Equity Report Fall 2013, Vol. 13, Number 4, Robert B. Kaplan, Kenneth J. Berman, John V. Ponyicsanyi; and [When the SEC Knocks on Your Door, Will You Be Prepared?: Practical Steps PE Firms Should Take to Prepare for an SEC "Presence" Examination](#), Private Equity Report Winter 2013, Vol. 13, Number 2, Kenneth J. Berman, Robert B. Kaplan, Michael P. Harrell, Jonathan R. Tuttle.

² In the Matter of Lincolnshire Management, Inc. Investment Advisers Act of 1940 Release No. 3927. September 22, 2014.

BACKGROUND

The matter involved two portfolio companies – Peripheral Computer Support, Inc. (“PCS”) and Computer Technology Solutions Corp. (“CTS”) – that were owned by separately managed private equity funds (“Fund I” and “Fund II”) with distinct sets of investors. The Manager of both funds, a registered investment adviser since 2012, concluded that the two companies should be integrated with the objective of ultimately exiting the two companies through a joint sale. Fund I acquired PCS in 1997. After Fund I’s investment period expired, Fund II acquired CTS in 2001. Throughout the investment and integration process, the Manager disclosed its intentions and provided regular updates to the limited partners of each fund.

From at least 2005 to 2013 (when both companies were jointly sold), PCS and CTS largely operated as integrated companies, although they remained two separate legal entities with separate audited financial statements. The Manager integrated the portfolio companies’ financial accounting systems, a variety of business and operations functions, financing, marketing and management.

PCS and CTS also developed and implemented a joint expense allocation policy that generally allocated expenses that benefited both portfolio companies based on their pro rata contribution to revenue of the integrated entity. There was no written guidance or detail accompanying the policy, nor were there any written agreements between the two companies relating to expense allocation. The SEC found that, while the expenses between PCS and CTS were generally allocated and documented properly, in certain instances a portion of the shared expenses was misallocated and went undocumented, resulting in one portfolio company paying more than its pro rata share of expenses that benefited both portfolio companies. In certain instances, salaries of shared employees and certain administrative expenses were not properly allocated. In addition, PCS’s wholly-owned Singapore subsidiary performed services for, and sold supplies and parts to, CTS at cost. However, CTS did not contribute to the general overhead costs of running the Singapore subsidiary.

VIOLATIONS

The SEC found that the Manager violated Rule 206(4)-7 under the Advisers Act – the “Compliance Rule” – by failing to adopt and implement written policies and procedures designed to prevent violations of the Advisers Act arising from the integration of PCS and CTS.

More significantly, the SEC found that the Manager violated Section 206(2) of the Advisers Act by causing one portfolio company (and, indirectly, the fund

that owned it) to pay more than its share of certain expenses that benefited both portfolio companies. The SEC concluded that this constituted a breach of the Manager's fiduciary duty owed to each fund.

A few aspects of the settlement are noteworthy. There was no suggestion that the misallocations were designed to systematically favor one private fund over the other, that the Manager benefited from the misallocations or that the failure to allocate in accordance with the policy had been deliberate. The SEC noted, however, that a finding of simple negligence is enough to result in a violation of Section 206(2) of the Advisers Act.

The sanctions are also noteworthy. In addition to a cease and desist order, the Manager was required to pay disgorgement of \$1,500,000, prejudgment interest of \$358,112, and a civil penalty of \$450,000, for a total of \$2,308,112. While the settlement does not address this point explicitly, it appears likely that a significant portion of the disgorgement related to misallocations that occurred before the Manager registered under the Advisers Act.

CONCLUSION

Private equity fund sponsors should ensure that they and their portfolio companies have written policies in place designed to fairly allocate all expenses – including fixed overhead expenses – among all entities that benefit from the activities driving such expenses and that none of the sponsor's clients are directly or indirectly benefited or harmed from allocation policies at the portfolio company level.

* * *

Please do not hesitate to contact us with any questions.