

Practice Update

SEC Sanctions Real Estate Fund Manager for Expense Allocation Violations

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On August 7, 2020, a real estate fund manager (fund manager) agreed to settle charges brought by the U.S. Securities and Exchange Commission (SEC) related to the fund manager's allocations and disclosures of costs and expenses. The case is an example of how the SEC has been increasingly focused on expense allocation issues and it demonstrates the importance of addressing how costs and expenses are calculated, allocated, and disclosed across multiple funds and co-investment vehicles.

In this specific case, the SEC alleged the fund manager failed to properly allocate and provide required disclosures relating to the costs and expenses of certain services provided by affiliates of the fund manager (affiliated services) to two of its real estate funds. The affiliated services consisted of asset-level due diligence, accounting, valuation, and other similar services that are often provided by unaffiliated third parties. The SEC found that from 2012 through 2017, the fund manager allocated to the funds approximately \$3 million more than their pro rata share of costs and expenses related to the affiliated services, which should have instead been allocated to certain related co-investment vehicles also managed by the fund manager.

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Each fund has an advisory committee composed of certain limited partners responsible for approving, among other things, costs and expenses charged to the fund, including those related to affiliated services. The offering documents of one of the funds provide that the fund manager is entitled to reimbursement for the costs and expenses of providing affiliated services to the fund only after the advisory committee receives disclosure of the affiliated services and “evidence indicating such fees and costs are at or below market rates.”

Beginning in 2012, and annually thereafter, the fund manager in this case provided the advisory committees with a memorandum detailing each fund’s allocable costs associated with the affiliated services provided by various employees of the fund manager and requesting reimbursement of the same. In each memo, the fund manager represented to the advisory committee that the costs and expenses charged to the funds for providing affiliated services were “at or below market rates.” However, while the fund manager conducted a market rate analysis in 2012, from 2013 to 2017 each memo provided to the advisory committees omitted that the fund manager failed to obtain updated information or perform any further analysis in continued support of such claims.

For services performed in 2011, the fund manager properly disclosed to the advisory committee of one fund that the cost allocation methodology used to calculate the costs and expenses associated with the affiliated services added 11 percent to the total cost for each employee to cover general overhead expenses. However, the allocation methodology the fund manager used from 2012 through 2017 increased the total cost for each employee to 25 percent. The fund manager did not fully disclose this increase to the advisory committees before being reimbursed for the costs and expenses associated with the affiliated services.

As a registered investment adviser, the fund manager is required to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940, as amended (the Advisers Act) and its rules. In addition to the disclosure issues discussed above, the SEC alleged the fund manager failed to adopt and implement written policies and procedures reasonably designed to ensure that the costs and expenses related to the affiliated services were properly calculated, allocated, and disclosed.

As a result of the foregoing alleged actions and omissions by the fund manager, the SEC found that the fund manager violated Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-7 and Rule 206(4)-8 thereunder. The SEC ordered the fund manager to cease and desist from committing or causing any such violations and any future violations of the same, censured the fund manager, and ordered the fund manager to pay a civil penalty of \$350,000. The fund manager had previously remediated the funds.

As a result of this case and the increased SEC scrutiny related to expense allocation, real estate fund managers should carefully review their policies and procedures to ensure that they are reasonably designed to address the way in which costs and expenses are calculated, allocated, and disclosed across multiple funds and co-investment vehicles. Where necessary, firm policies and procedures should be updated to align with the SEC's guidance on this matter. Additionally, fund offering documents should be carefully drafted and reviewed to ensure continuity with all firm policies and procedures and applicable SEC regulations.

For additional information please contact Paul Foley, Chair of Akerman's Investment Management Practice.

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