



CONSTELLATION  
ADVISERS, LLC

## REGULATORY NOTICE: 20-08

### Case Study: SEC Enforcement Action - Expense Allocation Considerations

*Expense allocations to fund clients related to adviser employees performing third-party tasks typically performed by outside professionals can backfire if done improperly*

The SEC recently issued an Order in an Administrative Proceeding related to an adviser performing in-house several third-party tasks (e.g., asset-level due diligence, accounting, valuation, etc.) and improperly allocating the in-house expenses to the adviser's fund clients for reimbursement. See *In the Matter of Rialto Capital Management, LLC*, IA Release No. 5558 (August 7, 2020) (order available [here](#)). Constellation has summarized points from Rialto that we believe are most relevant to our clients. <sup>[1]</sup>

#### Regulatory Requirement

Pursuant to Sections 206(2) and 206(4) of the Investment Advisers Act of 1940, and Rules 206(4)-7 and 206(4)-8 thereunder, registered investment advisers are required, among other things, to refrain from engaging in any act or practice that would be fraudulent, deceptive or manipulative; and to implement policies and procedures reasonably designed to prevent federal securities law violations. To comply with regulatory requirements, firms must implement policies and procedures that allocate expenses in a fair and equitable manner to the adviser's clients, disclose what expenses the adviser allocates to its clients, and follow the representations made to clients in various operative documents.

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[1] This summary is not intended to be a thorough or complete analysis of this enforcement action and is provided only for informational purposes to assist our clients in implementing appropriate processes and procedures related to expense allocations. Constellation does not practice law and this alert does not constitute legal advice.

#### Rialto's Violations According to the SEC's Order <sup>[2]</sup>

Rialto made various representations in its operative documents, including that it would: (1) perform in-house tasks typically assigned to third-party professionals; (2) include an allocable portion of the time Rialto's employees spent performing the third-party tasks as part of the costs and expenses charged to clients; (3) provide to the limited partnerships' advisory committees a schedule of fees and costs for third-party tasks performed by Rialto employees along with evidence that the fees and costs were at or below market rates; and (4) charge each of the clients their pro rata share of the third-party expenses.

Before the annual meeting each year, Rialto provided to the advisory committees a written memorandum requesting reimbursement of the costs and expenses related to Rialto's employees performing third-party tasks for the fund clients. The memorandum detailed each fund's allocable costs related to the performance of underwriting, loan management, real estate owned asset management, and accounting/tax/legal costs. After the annual meeting, Rialto was reimbursed by each fund client the approved amount of costs and expenses related to Rialto's employees performing the third-party tasks.

In 2011, Rialto disclosed to the only advisory committee in existence at that time "that the 2011 costs for third-party tasks added 11% of the total cost for each employee to cover general overhead expenses (Overhead Factor)." In 2012, Rialto conducted a market rate analysis to support its determination that the costs and expenses were at or below market rates. From 2013 to 2017, however, Rialto failed to (1) disclose to the advisory committees that Rialto had increased the Overhead Factor from 11% to 25%; and (2) obtain any updated information or perform any analysis to support the increased fees and costs related to the third-party tasks.

In addition, from 2012 through 2017, Rialto performed third-party tasks that related to its two fund clients and five co-investment vehicles, but failed to allocate any of the fees and costs to the co-investment vehicles. As a result, Rialto overcharged one fund client \$2.75 million and another fund client \$250,000.

Last, 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.

As a result, the SEC found that Rialto willfully violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940, and Rules 206(4)-7 and 206(4)-8 thereunder and ordered, among other things, the firm to pay a civil monetary penalty in the amount of \$350,000. <sup>[3]</sup>

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[2] The factual information and violations described herein are based on an Administrative Order entered by the SEC. The SEC indicated that the findings were made pursuant to an offer of settlement wherein the respondent consented to the entry of the order without admitting or denying the SEC's findings.

[3] Before the settlement, Rialto had already reimbursed the fund clients.

## TAKE ACTION!

### Takeaways - Clients Should:

- If you are performing tasks in-house and allocating those costs and expenses (e.g., portion of employees' salaries) to clients related to performing those tasks, then document how much time those employees spend on those tasks to support the expense allocation.
- If you are representing to clients that you will perform these tasks in-house at or below market rates, then obtain documentation to support this claim (i.e. obtain proposals from third parties to perform the work, obtain market survey data or reports, etc.)
- Confirm expenses being borne by clients and your expense allocation policies are consistent with client operative documents.
- Verify that your expense allocation process is executed consistent with the representations in the client operative documents.
- Document the process for allocating expenses to substantiate that the expense allocations are fair, equitable and comport with your policies, procedures and relevant operative documents.
- Contact Constellation as it has established an expense allocation independent analysis and monitoring service line to help our clients ensure that their expense allocation practices are properly disclosed and validated, periodically tested and closely monitored. Our professionals can provide guidance and assistance in performing and obtaining market rate analysis, and evaluating your current expense allocation policies and procedures.

***For more information, please contact us at [compliance@constellationadvisers.com](mailto:compliance@constellationadvisers.com).***

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