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SEC Action Against Private Fund Adviser Highlights Importance of Proper Expense Apportionment

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On November 5, 2015, the Securities and Exchange Commission (SEC) announced that it had reached a settlement with Cherokee Investment Partners, LLC (CIP) and Cherokee Advisers, LLC (CA), affiliated private equity fund managers based in Raleigh, North Carolina, in connection with improperly allocating $455,698 of the managers' regulatory expenses incurred between July 2011 and March 2015 to three funds they managed. In April 2015, the managers reimbursed the funds for the full amount of the misallocated regulatory expenses. In settlement of the matter, the managers agreed to collectively pay a $100,000 civil monetary penalty.

As a result of regulatory changes imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act, CIP began the process of registering as an investment adviser with the SEC in May 2011. CA did not independently seek independent registration and instead became a "relying adviser" of CIP in connection with the latter's registration. CIP incurred certain consulting and legal fees totaling $171,232 related to the registration process and other compliance-related expenses which the managers charged to the funds.

In 2013, the SEC staff conducted an examination of both CIP and CA. In the course of preparing for and responding to this examination, the managers incurred expenses relating to legal and consulting services of which they allocated $239,362 to the funds. In April 2014, the managers became the subject of an investigation by the SEC's Enforcement staff. In connection with responding to this investigation, CIP and CA incurred legal and other expenses of which they allocated $45,104 to the funds.

The Order settling the SEC's action against CIP and CA noted that while the funds' limited partnership agreements (LPAs) disclosed that the funds would be charged for expenses that in the good faith judgment of the funds' respective general partners arose out of the operation and activities of the funds (including legal and consulting expenses of the funds), the LPAs did not disclose that the funds would be charged for portions of the managers' legal, compliance and regulatory expenses. In agreeing to the $100,000 civil monetary penalty, the SEC specifically noted that it considered remedial acts taken by CIP and CA (i.e., the reimbursement of all misallocated expenses to the funds in April 2015) and cooperation afforded to the SEC staff.

Through this action and other similar recent settlements, the SEC has clearly indicated that managers may assign to the funds they manage only those expenses that are specifically and expressly identified in the funds' organizational and governing documents. Managers should examine their current and past practices in light of the relevant provisions in their documents. If there is uncertainty as to whether the manager was permitted to allocate certain expenses to a fund, managers should consider remedial steps, including reimbursements and/or amending the partnership agreements, and assess potential liabilities (including a review of existing insurance policies and indemnification provisions). As the SEC continues to analyze expense apportionments between managers and their funds, a proactive review of a manager's current allocation provisions is a prudent approach that may limit regulatory scrutiny.

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