SEC Enforcement Case Summary
Inadequate Disclosure and Consent for Affiliated Service Provider Expenses

On September 3, 2024, the SEC brought a settled enforcement action against private fund manager Colony Capital Investment Advisors, LLC for failure to follow contractually agreed procedures governing the timely disclosure of and consent to expenses allocated to eight private real estate funds. The limited partnership agreements (LPAs) for these funds addressed transactions that may create conflicts of interest and how such transactions would be disclosed and approved. The LPAs required that transactions with affiliates be fully disclosed in advance to the funds' limited partners and approved by the limited partner advisory committee (LPAC) or majority of limited partners. One LPA required that material amounts paid to affiliates be disclosed to the LPAC during the same fiscal year that expenses are incurred.

Colony managed multiple distressed credit funds and other real estate-related funds. The funds routinely entered into agreements with affiliated service providers of Colony and the general partners. Services included fund-level administrative fees, asset-level services, such as loan servicing, property maintenance, and property-level accounting. The funds paid approximately $3.6 million to affiliated service providers pursuant to such agreements.

Notwithstanding the LPA provisions requiring disclosure and consent, the SEC found that Colony failed to obtain LPAC or LP consent for any of the agreements. Moreover, the SEC noted that while the funds' audited financial statements did disclose the existence of such agreements and the expenses paid to affiliates pursuant to such agreements, such disclosure was not made until after the agreements had been entered into and expenses incurred.

The SEC also concluded that Colony violated Rule 206(4)-7 of the Investment Advisers Act of 1940 ("Advisers Act") by failing to adopt and to implement written policies and procedures that were reasonably designed to prevent violations the Advisers Act and its rules in connection with multiple aspects of its affiliated service provider program:

- the use of affiliated service providers by its private funds;
- the process for review and approval of agreements between the private funds and affiliated service providers;
- the determination of the arm's-length nature of transactions with affiliated service providers that was required by the Funds' LPAs; or
- complying with requirements in the LPAs related to analyzing the terms and conditions of or approving transactions with affiliates.

The SEC charged the firm with willfully violating Section 206(2) and Section 206(4) of the Advisers Act and the Private Fund Anti-Fraud Rule 206(4)-8. In addition, the firm was charged with failing to implement appropriate compliance policies and procedures to prevent such violations pursuant to Compliance Rule 206(4)-7. The SEC considered the firm's cooperation and voluntary reimbursement of certain expenses. The firm agreed to pay a $350,000 civil penalty to settle the case.

This case reminds private fund managers that the SEC a) continues to focus on fees paid to affiliated service providers, even if such fees may be market rate, and b) is reviewing for situations where conflicts of interest are brought before the LPAC or other governing body for consent (or by notice) as disclosed in the governing documents. The SEC further continues to find that disclosure made after the fact regarding the existence of such arrangements and amounts of compensation paid to affiliates does not cure failures to provide prior disclosure and seek consent.

See Summary - https://www.sec.gov/enforcement-litigation/administrative-proceedings/ia-6671-s