

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**INVESTMENT ADVISERS ACT OF 1940**  
**Release No. 5558 / August 7, 2020**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-19906**

**In the Matter of**

**RIALTO CAPITAL  
MANAGEMENT, LLC,**

**Respondent.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS,  
PURSUANT TO SECTIONS 203(e) AND  
203(k) OF THE INVESTMENT ADVISERS  
ACT OF 1940, MAKING FINDINGS, AND  
IMPOSING REMEDIAL SANCTIONS AND A  
CEASE-AND-DESIST ORDER**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against Rialto Capital Management, LLC (“Rialto” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Rialto has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Rialto consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

### III.

On the basis of this Order and Rialto's Offer, the Commission finds<sup>1</sup> that:

#### Summary

1. This matter concerns the manner in which registered investment adviser Rialto disclosed and allocated certain costs and expenses relating to its performance of "third party tasks" for two real estate private equity funds, Rialto Real Estate Fund, LP ("Fund I") and Rialto Real Estate Fund II, LP ("Fund II") (collectively, the "Funds"). Third party tasks for these Funds include asset-level due diligence, accounting, valuation, and other similar services that are typically performed for funds by outside professionals but may be performed in-house by the adviser to the fund ("Third Party Tasks").

2. A primary selling point of the Funds was Rialto's ability to perform Third Party Tasks in-house. According to the Funds' operating documents, Rialto is entitled to be reimbursed for the costs and expenses of providing Third Party Tasks to the Funds. From 2012 through 2017, Rialto misallocated to Fund I and Fund II costs and expenses related to its performance of Third Party Tasks that should have been allocated to related co-investment vehicles Rialto also managed. This resulted in Rialto charging the Funds approximately \$3 million more than their pro rata share of costs and expenses for Third Party Tasks that should have been paid by the co-investment vehicles. Rialto fully remediated the Funds.

3. The Funds are organized as limited partnerships and each has its own advisory committee composed of certain limited partners in each Fund ("Advisory Committee"). Rialto represented to the Advisory Committees that Rialto "[was] able to obtain information" supporting that costs and expenses Rialto charged to the Funds for providing Third Party Tasks were "at or below market rates." In 2012, Rialto conducted a market rate analysis, however, between 2013 to 2017, Rialto's disclosures to the Advisory Committees did not state that Rialto failed to obtain any updated information or perform any analysis supporting its claim that Rialto's costs were at or below market rates.

4. From 2012 to 2017, the cost allocation methodology Rialto used to calculate Third Party Tasks increased general overhead expenses. Rialto did not fully disclose this increase to the Advisory Committees.

5. In addition, Rialto failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

#### Respondent

6. Rialto, formed in 2007, is a Delaware limited liability company, with its principal place of business in Miami, Florida. Rialto has been registered as an investment adviser with the Commission since 2012. Rialto manages and advises multiple private equity funds, including the

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<sup>1</sup> The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Funds. As of December 31, 2019, Rialto had approximately \$4.8 billion in regulatory assets under management, comprised of approximately \$4.3 billion in private equity funds and co-investment vehicles and approximately \$470 million in separate accounts.

### **Relevant Entities**

7. The Funds are Delaware limited partnerships formed for the purpose of acquiring, owning, operating, and disposing of real estate and real estate-related investments. Rialto manages and advises the Funds.

8. Rialto Real Estate Fund-SG Co-investment, LP, Rialto Real Estate Fund CMBS AIV SG, LP, and Rialto Real Estate Fund CMBS AIV SG II, LP are co-investment vehicles formed to acquire, own, hold, maintain, service, administer, manage, and/or dispose of investments, primarily in real estate properties, real estate loans, and asset-backed securities (collectively, the “Fund I Co-Investment Vehicles”) alongside Fund I. Rialto manages and advises the Fund I Co-Investment Vehicles and also has a limited partnership interest in them.

9. Al Breck CI Partnership, LP and Rialto Real Estate Fund II CMBS AIV SG, LP are co-investment vehicles formed to acquire, own, hold, maintain, service, administer, manage, and/or dispose of investments, primarily in real estate properties, real estate loans, and asset-backed securities (collectively, the “Fund II Co-Investment Vehicles”) alongside Fund II. Rialto manages and advises the Fund II Co-Investment Vehicles and also has a limited partnership interest in them.

### **Background**

10. An affiliate of Rialto serves as the general partner of each Fund and has authority to make decisions for, and act on behalf of, the Funds. Rialto serves as the investment adviser to the Funds, as well as to the Funds I and II Co-Investment Vehicles (collectively, the “Co-Investment Vehicles”).

11. The terms of the Funds’ operations, including provisions concerning costs and expenses related to Third Party Tasks, are set forth in each Fund’s governing documents, including a limited partnership agreement (“LPA”). In addition, the terms of the investment advisory services that Rialto or its affiliate provides to the Funds are also set forth in the LPA for each of the Funds.

12. Each of the Funds has its own Advisory Committee. The LPAs provide that the Advisory Committee for each Fund is responsible for approving, among other things, costs and expenses charged to the Funds, including those related to Third Party Tasks.

13. The costs for Third Party Tasks include an allocable portion of the time Rialto employees spend performing Third Party Tasks and any related costs and expenses.

14. Each year, in advance of the annual meeting of each Advisory Committee, Rialto provides to the Advisory Committees a written memorandum (“Advisory Committee Memo”) requesting reimbursement for costs and expenses related to Rialto’s performance of Third Party Tasks for the Funds. The Advisory Committee Memo details, among other things, each Funds’

allocable costs associated with Third Party Tasks for the following categories of services: underwriting; loan management; real estate owned asset management; and accounting/tax/legal costs. Following consent by the Advisory Committees, Rialto is reimbursed the approved amount for Third Party Tasks by each Fund.

### **Misallocation of Costs and Expenses**

15. From 2012 through 2017, Rialto allocated certain costs and expenses relating to Third Party Tasks performed for the Co-Investment Vehicles to the Funds, rather than allocating each their proportional share of such expenses.

16. As a result, from 2012 to 2017, Rialto charged Fund I approximately \$2.75 million, and Fund II approximately \$250,000 more than their pro rata share of costs and expenses for Third Party Tasks that should have been paid by the Co-Investment Vehicles.

17. Rialto fully remediated the Funds.

### **Fund Disclosures**

18. Fund I's LPA requires that prior to the Fund paying or reimbursing Rialto for Third Party Tasks, Rialto must "provide the Advisory Committee a schedule of the fees and costs of such Third Party Task related to such payment and/or reimbursement and evidence indicating such fees and costs are at or below market rates." From 2013 to 2017, Rialto's Advisory Committee Memos represented that Rialto "[was] able to obtain information" supporting that Rialto's costs for providing Third Party Tasks "were at or below market rates." In 2012, Rialto conducted a market rate analysis, however, from 2013 to 2017, Rialto's disclosures to the Advisory Committees did not state that Rialto failed to obtain any updated information or perform any analysis supporting its claim that Rialto's costs for performing Third Party Tasks were at or below market rates.

19. Rialto disclosed to Fund I's Advisory Committee that the 2011 costs for Third Party Tasks added 11% to the total cost for each employee to cover general overhead expenses (the "Overhead Factor").<sup>2</sup> However, the cost allocation methodology Rialto used from 2012 through 2017 to calculate costs for Third Party Tasks increased the Overhead Factor from 11% to 25%. Rialto did not fully disclose to the Funds' Advisory Committees the increased Overhead Factor.

### **Compliance Policies and Procedures**

20. As a registered investment adviser, Rialto was required to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

21. Pursuant to the organizational documents of the Funds, in connection with performing Third Party Tasks, Rialto was responsible for the allocation of costs and expenses for Third Party Tasks among the Funds and Co-Investment Vehicles.

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<sup>2</sup> Fund II was not yet in existence in 2011.

22. Rialto failed to adopt and implement written policies and procedures reasonably designed such that costs and expenses related to Third Party Tasks were calculated, allocated, and disclosed properly.

### **Violations**

23. Section 206(2) of the Advisers Act prohibits investment advisers from directly or indirectly engaging “in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” A violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence; scienter is not required. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-95) (1963)). As a result of the conduct described above, Rialto willfully<sup>3</sup> violated Section 206(2) of the Advisers Act.

24. Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder make it unlawful for any investment adviser to a pooled investment vehicle to “[m]ake any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle” or to “engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.” A showing of negligence is sufficient to establish a violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. *Steadman*, 967 F.2d at 647. As a result of the conduct described above, Rialto willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

25. Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder require registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Adviser Act and its rules. As a result of the conduct described above, Rialto willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

### **Rialto’s Remedial Efforts**

26. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Rialto.

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<sup>3</sup> “Willfully,” for purposes of imposing relief under Sections 203(e) and 203(f) of the Advisers Act “means no more than that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). The decision in *The Robare Group, Ltd. v. SEC*, which construed the term “willfully” for purposes of a differently structured statutory provision, does not alter that standard. 922 F.3d 468, 478-79 (D.C. Cir. 2019) (setting forth the showing required to establish that a person has “willfully omit[ted]” material information from a required disclosure in violation of Section 207 of the Advisers Act).

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Rialto's Offer.

Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

- A. Rialto cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder.
- B. Rialto is censured.
- C. Rialto shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$350,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717.

Payment must be made in one of the following ways:

- (1) Rialto may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Rialto may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Rialto may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center  
Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Rialto as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Jessica M. Weissman, Assistant Regional Director, Division of Enforcement, Miami Regional Office, Securities and Exchange Commission, 801 Brickell Avenue, Suite 1950, Miami, FL 33131, or such other person or address as the Commission staff may provide.

D. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Rialto agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Rialto's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Rialto agrees that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Rialto by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Vanessa Countryman  
Secretary