Financial Regulatory Alert

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The SEC Is Kicking Off 2022 with a Renewed Focus on the Private Funds Industry: A Review of Recent Enforcement Actions and Their Lessons for Private Fund Managers

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Private funds should be prepared for increased oversight from the Securities and Exchange Commission (SEC), following a landmark year of enforcement cases. In 2021, the Commission brought 159 enforcement actions against registered investment advisors or investment companies, amounting to 23 percent of the total agency cases.[1] Indeed, the SEC brought more enforcement actions against registered investment advisors and companies than any other class of registrant last year. We expect—and have already seen—the SEC continue to be active in its enforcement against private funds this year.

Priorities Set by SEC Chair Gensler in the Private Funds Space

Chair Gary Gensler addressed the SEC's priorities in the private funds space during remarks that he made last November at the Institutional Limited Partners Association Summit.[2] In his remarks, Chair Gensler ran through a laundry list of specific focus areas that he has identified in the private funds industry. While Chair Gensler framed his comments as a discussion "about policies around market structure," the SEC's Division of Enforcement is likely to follow his lead. His remarks therefore can be viewed as a roadmap to the SEC's developing enforcement priorities in the private funds space.

- **Fees and Expenses**: As previously reported, Chair Gensler questioned "whether fund investors have enough transparency" with respect to the multiple levels of fees charged by private fund managers, such as management fees, performance fees and in the private equity space, portfolio company fees. He set the goal of promoting "additional transparency around fees and expenses to fund investors."
- **Fiduciary Duties and Conflicts of Interest**: Chair Gensler expressed concerns about efforts by fund managers to seek waivers of their state level fiduciary duties to investors. He stressed that, in addition to state law duties, "[a]n investment adviser to a private fund has a federal fiduciary duty to the fund enforceable under the Advisers Act" and "[t]his federal fiduciary duty may not be waived." He also has directed the Commission's staff to examine "how we can better mitigate the effects

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of conflicts of interest between general partners, their affiliates, and investors" and suggested that this "could include considering the need for prohibitions on certain conflicts and practices."

- **Performance Metrics**: Chair Gensler also tasked the Commission's staff with examining how to enhance transparency to private fund investors around performance metrics. In doing so he acknowledged, but did not weigh in on, the "debate about whether private equity outperforms the public markets net of fees, or taking into account leverage and liquidity."
- **Side Letters**: Chair Gensler expressed concerns about side letters that give certain private fund investors, but not others, preferred liquidity terms or disclosures. He stated that the SEC is examining how it can "strengthen transparency" to investors regarding side letters and "whether certain side letter provisions should not be permitted."
- **Form PF**: Chair Gensler emphasized the importance of Form PF, the means by which the SEC gathers information about hedge funds and private equity funds for the purpose of assessing market risk. He described Form PF as "critical to the Commission's oversight of private fund advisers" and previewed his agenda of amending Form PF to require the reporting of "more granular or timelier" information.[3]

Since Chair Gensler's remarks only a few months ago, the SEC's Division of Enforcement has already brought actions against investment advisers touching on several of these areas. In this alert, we review some of these enforcement actions and provide recommendations on what private fund managers can do to mitigate their regulatory risk going forward.

Fees and Expenses

SEC v. Glob. Infrastructure Mgmt., LLC

On December 20, 2021, the SEC announced a settlement with a private equity fund manager for false and misleading statements to investors concerning fee offsets.[4] According to the SEC, the firm failed to offset certain portfolio company fees against management fees charged to clients, as it was required to do under its offering and governing documents. Provisions of the firm's limited partnership agreements and private placement memoranda also inconsistently described the methodology used to calculate management fees for investors. In addition, the firm failed to adequately implement policies and procedures to ensure proper accounting of fees and expenses. As a result, investors overpaid the firm millions of dollars.

The SEC charged the adviser with negligence based violations of the antifraud provisions and failing to adopt reasonable policies and procedures under Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 and Rules 206(4)-7 and 206(4)-8. Without admitting or denying the findings, the adviser agreed to pay a $4.5 million penalty to settle the SEC charges. The order also noted that, prior to the settlement, the adviser had voluntarily repaid $5.4 million to affected investors.

This case demonstrates the ongoing importance of private fund managers having strong policies and procedures to ensure that fees and expenses are being calculated and applied in a manner that is consistent with the language of governing fund documents.

Conflicts of Interest and Waivers of Fiduciary Duties

SEC v. Comprehensive Cap. Mgmt., Inc.

On January 11, 2022, the SEC announced settled charges against a registered investment adviser that primarily served retail clients, alleging two separate sets of violations.[5]

First, the SEC found that, from 2017 through March 2021, the adviser falsely stated that it would mitigate conflicts of interest related to its use of an affiliated broker-dealer by ensuring that its clients would not bear the cost of any related brokerage commissions. As a result of these misleading disclosures, the adviser improperly charged 11 clients a total of $66,635.

Second, the firm's advisory agreements included liability disclaimer language, characterized as a "hedge clause," which the SEC found to be misleading. While the language of the hedge clause was modified over time, the final version cited in the SEC order read as follows:

[Adviser] and its [representatives] will be liable only for their own acts of gross negligence or willful misconduct. [Adviser] and its [representatives] will not be liable for any act or omission, or the failure or inability to perform any obligation, of any broker, dealer, investment adviser, sub-custodian or other agent, including affiliates, whom [Adviser] selected with reasonable care. [Adviser] will not be liable for any incidental, indirect, special, punitive or consequential damages. Federal and state securities laws may nonetheless impose liability on persons who act in good faith and nothing in this Agreement shall serve to waive or limit any rights Client may have under those laws.[6]

The SEC took the position that the hedge clause inaccurately purported to relieve the adviser from liability for conduct for which its clients had a non-waivable cause of action under federal law. In particular, the SEC took issue with the language stating that the adviser would be liable only for its "own acts of gross negligence or willful misconduct." The SEC found that this was an inaccurate statement of the liability standards under the federal securities laws as they apply to investment advisers. The SEC found the language was misleading even though the final sentence of the clause acknowledged that "[f]ederal and state securities laws may nonetheless impose liability on persons who act in good faith and nothing in this Agreement shall serve to waive or limit any rights Client may have under those laws."

The primary concern of the SEC appeared to center on a belief that the language could mislead unsophisticated clients into foregoing the exercise of their legal rights. The SEC placed particular emphasis on the fact that "[m]ost, if not all, of the [adviser's] clients" were retail investors. The SEC also criticized the adviser for failing to have "policies and procedures to assess a client's sophistication in the law or to explain the meaning of the non-waiver disclosure." As support for this position, the order also cited the June 5, 2019, "*Commission Interpretation Regarding Standard of Conduct for Investment Advisers*," which states that "there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with [] antifraud provisions[.]"

The SEC charged the adviser with negligence based violations of the antifraud provisions, as well as violations of the policies and procedures and recordkeeping provisions, under Sections 204(a), 206(2) and 206(4) of the Advisers Act, along with

Rules 204-2(a)(8) and 206(4)-7. Without admitting or denying the findings, the adviser agreed to pay to a $300,000 penalty and disgorgement and prejudgment interest totaling $75,654.

This case shows that, in line with Chair Gensler's comments, the SEC's Enforcement Division is willing to scrutinize hedge clauses and similar fiduciary duty modifications, particularly when those clauses may impact retail investors. The case also highlights the risks associated with failures to identify and appropriately address conflicts of interest, regardless of whether the dollar amounts involved may be relatively small.

Performance Metrics and Marketing Materials

SEC v. CMG Cap. Mgmt. Grp., Inc.

On January 13, 2022, the SEC announced settled charges against a quantitative fund manager for failing to adopt and implement reasonable policies and procedures concerning its client advertisements.[7] In particular, between April 2017 and July 2018, the adviser advertised hypothetical, backtested performance results without disclosing certain dissimilarities between the backtest and the live versions of the strategy. For instance, the adviser did not disclose that the backtest and live strategy utilized different securities when constructing a model portfolio. The adviser also failed to preserve the advertisements as required by the recordkeeping rules.

The SEC charged the adviser with failing to have reasonably designed policies and procedures and violations of the recordkeeping rules under Sections 204(a) and 206(4) of the Advisers Act and Rules 204-2(a)(11) and 206(4)-7 thereunder. Without admitting or denying the findings, the adviser agreed to pay a civil penalty of $70,000. The settled order did not contain any findings of violations of the antifraud provisions of the Advisers Act.

This case shows the importance of funds maintaining strong policies and procedures regarding the reporting of performance metrics in marketing materials. In particular, private fund managers should ensure that disclosures are fulsome enough to avoid allegations that they have omitted facts, which could be material to an investor's ability to assess fund metrics. While this case involved hypothetical performance, it holds similar lessons for advisers preparing marketing materials or other similar investor facing documents, which contain track records or other performance metrics.

Key Takeaways

We expect the SEC's Division of Enforcement to continue to step up its efforts to police the private funds industry throughout 2022, with a focus on the areas Chair Gensler chose to highlight in his remarks this past fall. Accordingly, private fund managers should consider taking the following steps:

- Review practices regarding the calculation and allocation of fees and expenses and ensure consistency with the language in the firm's governing documents. Consider whether disclosures sufficiently address multilayered fees and expenses, such as portfolio company fees.
- Assess the language of hedge clauses and exculpation provisions, especially if clients include retail investors.

- Assess potential conflicts of interest between investment advisers and other fund entities and key firm personnel. Consider whether additional procedures are needed to identify potential conflicts and whether applicable disclosures should be revised.
- Review policies, procedures and practices regarding the preparation of marketing materials and other investor disclosure documents that contain hypothetical or actual fund performance metrics.
- Assess disclosures and practices regarding side letters. While we have not yet identified a recent enforcement action on this topic, Chair Gensler's comments suggest this is an area where there may be heightened enforcement going forward.
- Review internal policies, procedures, and practices to ensure proper and timely Form PF filings. While Chair Gensler's remarks on this topic focused on his rulemaking agenda, the SEC has a history of conducting enforcement "sweeps" involving coordinated actions against private fund managers with delinquent Form PF filings.[8]

Under Chair Gensler's leadership, the SEC has taken on an ambitious agenda for 2022, which includes increased regulation of the private funds industry. The Division of Enforcement will play an important role in implementing that agenda by stepping up its efforts to investigate potential misconduct involving private funds, particularly within the focus areas that Chair Gensler has staked out in his public remarks. The Division of Examinations can be expected to follow a similar agenda in close collaboration with their colleagues in Enforcement. This of course means increased regulatory risk for private fund managers. However, managers can effectively mitigate that risk by being attentive to the SEC's agenda and taking proactive compliance measures, especially in the areas where the SEC has expressed concerns.

[1] *See* Kenneth Corbin, *Investment Advisors Are Most Targeted by SEC Enforcement in 2021*, Barron's (Nov. 22, 2021), https://www.barrons.com/advisor/articles/investment-advisors-sec-enforcement-2021-51637587930.

[2] Chair Gary Gensler, SEC, Prepared Remarks At the Institutional Limited Partners Association Summit (Nov. 10, 2021), https://www.sec.gov/news/speech/gensler-ilpa-20211110.

[3] The SEC voted to propose amendments to Form PF on January 26, 2022. SEC Press Release 2022-9, *SEC Proposes Amendments to Enhance Private Fund Reporting* (Jan. 26, 2022), https://www.sec.gov/news/press-release/2022-9. The vote triggers a public notice and comment period on the proposed amendments.

[4] *Global Infrastructure Mgmt., LLC*, Release No. 5930, File No. 3-20683 (SEC Dec. 20, 2021), https://www.sec.gov/litigation/admin/2021/ia-5930.pdf.

[5] *Comprehensive Cap. Mgmt., Inc.*, Release No. 5943, File No. 3-20700 (SEC Jan. 11, 2022), https://www.sec.gov/litigation/admin/2022/ia-5943.pdf.

[6] *Id*. at ¶ 13 (emphasis added).

[7] *CMG Cap. Mgmt. Grp., Inc.*, Release No. 5945, File No. 3-20702 (SEC Jan. 13, 2022), https://www.sec.gov/litigation/admin/2022/ia-5945.pdf.

[8] *See* SEC Press Release 2018-100, SEC Charges *13 Private Fund Advisers for Repeated Filing Failures* (June 1, 2018), https://www.sec.gov/news/press-release/2018-100.

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