Securities Litigation Alert

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Private Funds Remain a Top Priority for the SEC in 2022: A Review of Recent Cases and Their Implications for Private Fund Managers

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Overview

Late last year, Securities and Exchange Commission (SEC) Chair Gary Gensler warned private fund managers that they should be prepared for increased regulatory scrutiny. Shortly thereafter, in February 2022, the SEC announced a historically sweeping set of rule proposals focused on the private fund industry. These proposals have coincided with a wave of enforcement actions impacting private fund managers, which made good on Chair Gensler's promise. The cases run the gamut, involving scienter-based allegations of fraud and breach of fiduciary duty to strict liability violations of technical rules. Below is a summary of a selection of these cases, which provide a roadmap to the agency's enforcement priorities as we wrap up 2022 and head into the new year.

Disclosure Cases

Fees and Expenses

A perennial issue, fees and expenses remain a top focus area for the SEC's Division of Enforcement.

"2 and 20" Fee Disclosure Case

- In March 2022, the SEC brought an enforcement action against Alumni Ventures Group, LLC (AVG), an exempt reporting adviser and venture capital fund manager, and its CEO, finding that AVG's marketing materials and other investor communications falsely claimed that its management fee was the "industry standard '2 and 20.'"[1] The SEC found that the manager did not collect a 2 percent management fee and a 20 percent performance fee; rather, it collected a 20 percent management fee upon an investor's initial investment.
- The SEC also found that AVG failed to disclose to investors that it made inter-fund loans and cash transfers. The commingling of these funds violated the funds' operating agreements, and the SEC found that AVG breached its fiduciary duties to the funds in doing so.

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- AVG and its CEO consented to the entry of an order finding that they negligently violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and that AVG violated Rule 206(4)-8 thereunder and agreed to pay $800,000 in penalties.

Misallocation of Expenses Among Fund and Co-Investors

- In June 2022, the SEC charged private equity adviser Energy Capital Partners Management, LP (ECP) in connection with a take-private transaction that was financed in part by a fund that it advised and in part by a group of co-investors. The SEC found that the manager allocated a disproportionate share of expenses to the fund without providing proper disclosure.[2]
- In connection with the transaction, ECP had agreed to pay commitment fees associated with a bridge loan facility. ECP initially sought to allocate these commitment fees to all investors pro rata, but the co-investors objected. ECP then changed course and allocated the fund more than its pro rata share to cover the fees that were not paid by the co-investors. The SEC determined that this was inconsistent with language in the fund documents that stated fees would be allocated "based on the relative investments and/or benefits derived among the [funds]" and/or "in any manner determined equitable, in the good faith judgment" of ECP.
- ECP consented to an order finding that it had negligently violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder, agreeing to pay a $1 million penalty. Prior to the settlement, ECP had voluntarily returned roughly $3.3 million in disproportionately allocated fees to the affected fund.

Miscalculation of Management Fees

- In early September 2022, the SEC brought an enforcement action against venture capital adviser Energy Innovation Capital Management, LLC (EIC) for charging excess management fees to two of the funds that it managed.[3]
- The SEC determined that EIC calculated its management fees in a manner inconsistent with what was required by its fund documents, resulting in the funds paying roughly $680,000 more in management fees than they should have.
- EIC consented to an order finding that it had negligently violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder and agreed to pay a $175,000 penalty. Prior to the settlement, EIC also voluntarily repaid its funds the excess fees plus interest.

ESG

Recently, the SEC has expanded the scope of its interest in environmental, social and governance (ESG) issues to the private fund industry.

Failure to Follow ESG Scoring Procedures Described in Investor Disclosures

- In May 2022, the SEC charged BNY Mellon Investment Adviser, Inc. (BNY) in its first ESG-related investment adviser disclosure case.[4]
- The SEC found that BNY represented to investors via mutual fund prospectuses and requests for proposals that its sub-adviser had conducted an ESG review for all

investments made by the mutual funds BNY advised. However, BNY made numerous investments for the funds for which there had not been any ESG review.

- The SEC found that BNY's conduct negligently violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-8 and 206(4)-7 thereunder and Section 34(b) of the Investment Company Act. BNY agreed to pay a $1.5 million penalty.
- The BNY case is not likely to be the end of the SEC's scrutiny of ESG-related practices by private fund managers. The Division of Examinations has recently conducted registered investment adviser examinations where ESG practices have been a primary focus.

Conflicts of Interest

Conflicts of interest also continue to be a top priority of the SEC's Division of Enforcement.

SPAC-Related Conflicts Case

- In September 2022, the SEC charged Perceptive Advisors LLC (Perceptive) for failing to disclose conflicts of interest arising out of its involvement in the formation of special purpose acquisition companies (SPACs).[5]
- The sponsor for the first SPAC formed by Perceptive was 100 percent owned by its funds. Perceptive then formed three other SPACs for which the sponsor interests were partially owned by the fund and partially owned by several members of Perceptive's investment team.
- Perceptive's fund subsequently participated in the private investment in public equity (PIPE) transactions that financed the SPACs' eventual business combinations. The SEC found that a conflict of interest existed because the investment professionals would benefit financially from the business combinations through their personal ownership interests in some of the SPAC sponsors. In the SEC's view, this could have influenced Perspective's decision to cause the fund to make the PIPE investments.
- The SEC found that, in addition to failing to disclose this conflict in a timely manner to the fund's Board of Directors, Perceptive made materially misleading statements to its investors regarding the SPACs. Specifically, Perceptive represented to its fund investors that it had sponsored all of the SPACs without disclosing that some of the sponsors were partially owned by Perceptive personnel.
- In a settled order, the SEC found that Perceptive negligently violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The SEC also charged Perceptive with violating Section 13(d) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 13d-1 thereunder for failing to timely switch to a Schedule 13D from a Schedule 13G and for purchasing during the resulting "cooling off period." Perceptive agreed to pay a $1.5 million penalty.
- The Perceptive action has at least two takeaways. First, the SEC remains focused on the SPAC space and how it has intersected with the private fund industry and related conflicts of interest. Second, and more broadly, the SEC is willing to aggressively pursue enforcement actions in matters where it believes that conflicts have not been promptly and appropriately disclosed.

Valuation Cases

Another familiar area where we have seen recent SEC enforcement activity is allegedly unlawful fund valuation practices. These cases range from matters involving allegations of fraud to situations where private fund managers were found to have deficient procedures related to the valuation of fund assets.

Fraudulent Valuations

- In February 2022, the SEC charged the former Chief Investment Officer (CIO) and founder of Infinity Q Capital Management LLC (Infinity Q), a registered investment adviser, with fraudulently overvaluing by more than $1 billion assets held by a mutual fund and a private fund that Infinity Q managed.[6]
- The complaint alleges that the CIO represented to Infinity Q's investors that the funds' assets were valued by an independent third-party pricing service, when instead, he manipulated the third-party valuation models and altered inputs to hide the funds' poor performance.
- The SEC charged the CIO with violating Section 17(a) of the Securities Act of 1933; Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; Sections 204(a), 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2(a), 206(4)-7, and 206(4)-8 thereunder; and Sections 34(b) and 37 of the Investment Company Act and Rule 22c-1 thereunder.
- In the accompanying press release, SEC Enforcement Director Gurbir Grewal emphasized the agency's "commitment to using all [of its] tools to root out misconduct in the $18 trillion private fund arena, a growing market attracting more and more institutional investors, including public pension funds, university endowments, and charitable foundations."[7]
- The CIO was also charged criminally by the U.S. Attorney's Office for the Southern District of New York (SDNY) based on the same conduct.

Valuation Policies and Procedures

- In June 2022, the SEC charged AlphaCentric Advisors LLC (AlphaCentric), a registered investment adviser, with violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder for failing to adopt policies and procedures that were reasonably designed to oversee a portfolio manager who engaged in improper valuation practices.[8]
- The SEC found that the portfolio manager: (1) purchased small "odd-lot" bonds and caused one of AlphaCentric's funds to value those holdings at higher prices provided by a pricing service for larger "round lot" bonds, and (2) improperly placed bids on bonds that the fund already held in order to increase the prices the fund relied on to value its holdings. The SEC found that these practices were inconsistent with the fund's valuation procedures and that the firm took insufficient steps to prevent this conduct.
- AlphaCentric agreed to pay a $300,000 penalty.

Uptick in Enforcement Actions for Non-Scienter Based Rule Violations

In the past six months, the SEC has brought a series of cases against private fund managers for violations of the custody, proxy voting and pay-to-play rules, as well as

Rule 105 of Regulation M. These cases evidence that the SEC may be returning to a "broken windows"-style approach to enforcement and is prepared to bring actions against investment advisers for technical violations that arguably caused no measurable harm to investors.

Custody Rule Violations

- In September 2022, the SEC announced charges against multiple investment advisers for violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which is commonly referred to as the "custody rule." Certain of the investment advisers were also charged with failing to update their Form ADVs in violation of Section 204(a) and Rule 204-1(a) thereunder.[9]
- In these actions, the SEC found that the advisers failed to timely deliver audited financials to their fund investors, thus violating the custody rule. The SEC determined that certain of these investment advisers also did not timely update their Form ADVs after receiving audited financials when the investment advisers previously indicated that the audited financial statements were "not yet received." The investment advisers agreed to pay penalties ranging from $50,000 to $330,000.

Proxy Voting Rule Violations

- In September 2022, the SEC brought an action against registered investment adviser Toews Corporation (Toews) for violating Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-6 thereunder (*i.e.*, the proxy voting rule) in connection with its proxy voting practices.[10]
- In particular, the SEC found that Toews directed its third-party vendor to vote the registered investment companies' (RIC) proxies without determining whether the proxy votes were cast in the best interest of the clients. Specifically, Toews instructed the vendor to cast the votes per a standing instruction to always vote in favor of proposals put forth by the issuers' management and against proposals by any shareholders. Toews consented to the order and agreed to pay $150,000 in penalties.

Pay-to-Play Rule Violations

- In September 2022, the SEC simultaneously announced multiple enforcement actions for violations of the pay-to-play rule, Rule 206(4)-5 of the Advisers Act.[11] These cases did not involve any allegations of intentional misconduct, and the donations at issue were all in the amount of $1,000 or less, underscoring the strict liability and draconian nature of the pay-to-play rule. Notably, Commissioner Hester Peirce dissented against these enforcement actions, criticizing the SEC's application of the rule in these matters.[12]

Regulation M

- In June 2022, the SEC charged a private fund manager with violations of Rule 105 of Regulation M under the Exchange Act for purchasing stock in seven public offerings during the restricted period after selling short those same stocks.[13]
- The private fund manager agreed to disgorge the $6.5 million in profits it made from the violations, plus interest. The SEC imposed only a $200,000 penalty, crediting the fund manager for self-reporting the violations and its cooperation in the SEC's investigation.

- While the SEC has a long history of bringing enforcement actions under Regulation M, this case serves as a reminder of the Enforcement Division's continued willingness to bring these types of actions, making full use of the regulation's strict liability standard.

Recordkeeping Rule Enforcement Actions

- On September 27, 2022, the SEC announced settlements for over $1.1 billion in penalties against several top tier banks for books and recordkeeping violations based on a failure to take sufficient steps to preserve business communications. While the firms charged were primarily banks subject to the broker-dealer recordkeeping requirements of the Exchange Act, one of the firms involved was also a registered investment adviser. In the order involving that firm, the SEC also cited violations of the recordkeeping rules of Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder.[14]
- In the settled orders, the SEC found that bank employees, including senior personnel, often communicated about business matters using "off-channel communications" such as text messages, WhatsApp and other non-firm approved messaging platforms.
- None of these communications were retained by the banks, even though, according to the SEC, the communications related to the banks' business were books and records required to be maintained under the federal securities laws and company policies.
- Recently, it was reported that the SEC has sent information requests to multiple investment advisers seeking information regarding electronic communications policies and usage, which track the approach that the agency took in the investigations that preceded the bank actions.[15]

Continued Aggressive Approach to Enforcement Actions Involving Insider Trading

The Lloyd Reed Case – What is MNPI?

- In April 2022, the SEC brought a settled enforcement action against an individual named Lloyd Reed for trading in the securities of Torotel, Inc. while in possession of material nonpublic information (MNPI) that the company would be acquired.[16]
- Reed allegedly obtained the MNPI from his business partner who was also a Torotel board member. Notably, Reed purchased Torotel securities both before and after he was told about the deal by his business partner.
- The SEC found that Reed had MNPI about the transaction even before his partner told him about the deal because:
  - Several years before the trading occurred, Reed's partner had given him a copy of a confidential memo suggesting that Torotel should consider putting itself up for sale.
  - Shortly before trading, Reed noticed that his business partner was repeatedly canceling meetings they had scheduled because the partner was making frequent trips to Torotel's offices.
- Commissioner Peirce issued a public dissent from the settlement, criticizing the portion of the SEC's order that found Reed could be viewed as possessing MNPI

based on his observations about his partner's travel activity, before being told about the transaction.[17]

- While this case did not involve a private fund manager, it reflects the SEC's willingness to push the envelope on the definition of insider trading under the current administration, even in the face of dissent from a minority of Commissioners.

Cryptocurrency Insider Trading Case

- In July 2022, the SEC brought insider trading charges under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder against former manager Ishan Wahi at Coinbase Global Inc. (Coinbase), a crypto asset trading platform in the United States, and his brother and a friend.[18] The SEC alleged that Wahi provided MNPI to the tippees regarding what digital assets Coinbase was planning to list on its exchange prior to Coinbase making a public announcement.
- The tippees allegedly used the MNPI to purchase certain crypto assets and then, following an increase in price after the listing announcement by Coinbase, sell those assets at a premium.
- Most notable from the SEC's allegations is its determination that certain—but not all—of the crypto assets traded based on MNPI were "securities." In particular, the SEC found that at least nine of the 25 tokens that were traded were securities under the *Howey* test.[19]
- Wahi and his tippees were also charged criminally by the SDNY. Interestingly, the SDNY elected not to bring securities fraud charges, but instead indicted the defendants for wire fraud, which unlike Section 10(b) and Rule 10b-5 is not limited to schemes that occur "in connection with the purchase or sale of [a] security."
- Although this case did not involve private fund managers, it has implications for firms that are involved in the cryptocurrency space. Such managers should review their policies and procedures regarding insider trading and personal trading to ensure they sufficiently cover the risks associated with the firm's activity in the cryptocurrency markets.

Key Lessons

We expect the SEC's Division of Enforcement to continue to pursue similar enforcement actions against the private fund industry in 2023. Private fund managers should consider the following takeaways from the recent enforcement actions:

- Private fund managers should continually monitor disclosures, especially regarding fees and expenses, ESG and conflicts of interest to make sure their disclosures are in step with actual practices. This is especially important where advisers are experiencing significant growth in their businesses or changes in their investment strategies. In addition, the SEC will test statements regarding investment advisers' fees and investment process, so investment advisers should be prepared to substantiate those claims.
- The SEC also appears to have brought back the "broken windows" approach to enforcement actions involving non-scienter based rule violations such as the pay-to-play, custody and proxy voting rules, as well as Regulation M. Private fund managers should consider revisiting their policies and procedures in these areas and incorporating them into training modules and annual compliance reviews.

- Consistent with the “broken windows” theme, the SEC appears to be actively investigating whether private fund managers have sufficient electronic communications procedures to satisfy their books and records obligations under the Advisers Act. Now is a good time to assess your electronic communications policies and emphasize the importance of compliance, including to senior personnel.
- Insider trading continues to be a top enforcement priority where the SEC is willing to push the envelope, especially in cases involving “bad optics.” Private fund managers should continue to focus on insider trading training for investment personnel and ensure they have strong surveillance measures in place to mitigate this risk.
- The SEC continues to bolster its oversight of the markets for cryptocurrency and other digital assets. The SEC’s apparent default position that most digital assets are “securities” should be considered as private fund managers that are active in the space assess their compliance programs.

[1] *Alumni Ventures Group, LLC and Michael Collins*, Release No. 5975, File No. 3-20791 (SEC Mar. 4, 2022), https://www.sec.gov/litigation/admin/2022/ia-5975.pdf.

[2] *Energy Capital Partners Management, LP*, Release No. 6049, File No. 3-20900 (SEC June 14, 2022), https://www.sec.gov/litigation/admin/2022/ia-6049.pdf.

[3] *Energy Innovation Capital Management, LLC*, Release No. 6104, File No. 3-21029 (SEC Sept. 2, 2022), https://www.sec.gov/litigation/admin/2022/ia-6104.pdf.

[4] *BNY Mellon Investment Adviser, Inc.*, Release No. 6032, File No. 3-20867 (SEC May 23, 2022), https://www.sec.gov/litigation/admin/2022/ia-6032.pdf.

[5] *Perceptive Advisors LLC*, Release No. 6105, File No. 3-21031, (SEC Sept. 6, 2022), https://www.sec.gov/litigation/admin/2022/34-95673.pdf.

[6] Complaint, *SEC v. Velissaris*, No. 22-cv-01346 (S.D.N.Y. Feb. 17, 2022), https://www.sec.gov/litigation/complaints/2022/comp-pr2022-29.pdf.

[7] SEC Press Release 2022-29, *SEC Charges Infinity Q Founder with Orchestrating Massive Valuation Fraud* (Feb. 17, 2022), https://www.sec.gov/news/press-release/2022-29.

[8] *AlphaCentric Advisers LLC*, Release No. 6040, File No. 3-20877 (SEC June 3, 2022), https://www.sec.gov/litigation/admin/2022/ia-6040.pdf.

[9] SEC Press Release 2022-156, *SEC Charges Two Advisory Firms Custody Rule Violations, One for Form ADV Violations, and Six for Both* (Sept. 9, 2022), https://www.sec.gov/news/press-release/2022-156.

[10] *Toews Corporation*, Release No. 6139, File No. 3-21113 (SEC Sept. 20, 2022), https://www.sec.gov/litigation/admin/2022/ia-6139.pdf.

[11] Akin Gump Client Alert, *SEC Fines Four Investment Advisers for Violating Pay-to-Play Restrictions* (Sept. 27, 2022), https://www.akingump.com/en/news-insights/sec-fines-four-investment-advisers-for-violating-federal-pay-to-play-restrictions.html.

[12] Statement by Commissioner Hester M. Peirce, *Laudable Ends, Poorly Pursued: Statement Regarding Recent Pay-to-Play Rule Settlements* (Sept. 15, 2022), https://www.sec.gov/news/statement/peirce-statement-pay-play-rule-settlements-091522.

[13] Exchange Act Release No. 95099, File No. 3-20899, https://www.sec.gov/litigation/admin/2022/34-95099.pdf.

[14] *See* SEC Press Release 2022-156, *SEC Charges 16 Wall Street Firms with Widespread Recordkeeping Failures* (Sept. 27, 2022), https://www.sec.gov/news/press-release/2022-174.

[15] *See* Chris Prentice, *SEC Scrutiny into Wall Street Communications Shifts to Investment Funds*, Reuters (Oct. 11, 2022), https://www.reuters.com/business/sec-scrutiny-into-wall-street-communications-widens-investment-funds-sources-2022-10-11/.

[16] *In the Matter of Lloyd D. Reed*, Release No. 94591, File No. 3-20810 (SEC Apr. 4, 2022), https://www.sec.gov/litigation/admin/2022/34-94591.pdf.

[17] Statement by Commissioner Hester M. Peirce, *In the Matter of Lloyd D. Reed* (Apr. 5, 2022), https://www.sec.gov/news/statement/peirce-lloyd-reed-20220405.

[18] Complaint, *SEC v. Ishan Wahi, et al*., No. 22-cv-01009 (W.D. Wash. July 21, 2022), https://www.sec.gov/litigation/complaints/2022/comp-pr2022-127.pdf.

[19] *Id*. at 23. The SEC found these assets (i) were "offered and sold by the issuer to raise money for the issuer's business," (ii) "the issuers directly sold crypto asset securities to investors in return for consideration" and (iii) "issuers and their management teams [touted] the investment value of the tokens, the managerial efforts that contribute to the tokens' value, and the availability of secondary markets for trading the tokens . . . [such that] a reasonable investor in the nine crypto asset securities would continue to look to the efforts of the issuer and its promoters, including their future efforts, to increase the value of their investment."

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