Katten

FINANCIAL MARKETS AND FUNDS ADVISORY

SEC Enforcement Actions Against Fund Advisers Continues

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KEY POINTS

- Recent Securities and Exchange Commission (SEC) enforcement actions against investment advisers and fund managers point to continued pressure points in the areas of conflicts of interest and disclosures to fund investors and clients.
- Several of these cases involved alleged misleading disclosures, misallocation of fees and expenses and conflicts of interest.

In the past few weeks, there has been a flurry of SEC enforcement actions against investment advisers and managers of private funds and mutual funds. These cases, like previous cases, provide important lessons to fund managers and demonstrate the SEC's continued focus on conflicts of interest and disclosures to fund investors and clients.

More of the Same — Misallocation of Fees and Expenses and Conflicts, Conflicts and More Conflicts

The SEC's intense enforcement focus on hedge funds and private equity funds, along with their managers, continues with a number of recent case concerning alleged misleading disclosures, misallocation of fees and expenses and conflicts of interest.

Misallocation of fees and expenses

This has been the topic of numerous SEC enforcement actions and remains one of the most common source of enforcement allegations and SEC comments in inspection deficiency letters.

In a recent case, the SEC alleged that from April 2012 through December 2016 an investment adviser to a private equity fund improperly charged the fund for expenses of employees of the adviser's operations group.[1] The operations group provided operationally focused services to the private equity fund (i.e., services related to making business improvements for the fund's portfolio companies operations). According to the SEC, the fund's governing document disclosed that portfolio companies were responsible for paying the adviser certain fees, including "'closing fees, investment banking fees, placement fees, monitoring fees, consulting fees, directors fees and other similar fees,' which would be partially offset against management fees unless they were for services provided to portfolio companies in the 'ordinary course of business'." However, said the SEC, there was no specific mention that the adviser's operations group or disclosure that the investment adviser would receive compensation-related fees for these employees from the portfolio companies.

[1] *In re* Monomoy Capital Management, L.P., Admin. Pro. No. 3-19764 (April 22, 2020).

In March 2014, the adviser filed a Form ADV that subsequently disclosed that "under specific circumstances, certain [of the adviser's] operating professionals may provide services to portfolio companies that typically would otherwise be performed by third parties," and that "[the investment adviser] may be reimbursed" for costs related to such services. However, the SEC found that these disclosures were deficient because they "did not fully and fairly disclose" that the adviser routinely provided these services and did, in fact, receive reimbursements from portfolio companies for the services, which were designed to recoup most of the investment adviser's costs. Notably, the SEC also pointed out specifically that the Form ADV did not mention these facts in the Form ADV's Summary of Material Changes. This case further highlights the SEC staff's views on what the staff considers to be inadequate subsequent disclosure and investor consent.

For these reasons, according to the SEC, the disclosures were not "sufficiently specific that [fund investors] could understand the conflicts of interest and have a basis on which they could consent to or reject this practice." The SEC order found that the investment adviser violated the Section 206(2) of the Investment Advisers Act of 1940 and the adviser was censured, agreed to a cease-and-desist order, and agreed to pay a civil penalty and disgorgement (with interest), totaling to approximately $1.9 million.

Inadequate risk management and misleading investors

On April 30, the SEC sued a private fund adviser and its principal for providing misleading information to investors regarding the fund's currency exposure and failing to apply its risk management procedures to currency investments.[2] According the SEC order, the adviser claimed in the fund's offering documents that:

- the fund would not concentrate its investments in any single geographic region;
- the adviser's "disciplined investment management style" was "driven by risk management";
- the adviser's risk management team "monitors all mandated risk limits of each strategy and end-of-day reviews" and "enforces strict adherence to these limits, and has the ability to reduce risk independent of the investment team"; and
- the fund's risk management team could reduce risk independent of investment adviser's investment team.

The SEC alleged that, despite these claims, the adviser did not apply the promised risk management to the fund's currency investment. Specifically, "currency trades taken on by the fund were not subject to risk monitoring, risk limits, risk review or automatic, independent risk reduction measures." According to the SEC, this resulted in the fund making "highly concentrated investments in the euro to Swiss franc exchange rate ('EUR/CHF Position') . . . [with] gross exposure . . . rang[ing] from approximately 400% to over 900%" from September 4, 2014 through January 15, 2015. According to the SEC order, on January 15, 2015, the Swiss franc rose more than 30% versus the euro and the fund sustained losses exceeding its assets.

The SEC's order also alleged that currency exposure was not reported to investors, and the fund's offering materials were misleading, because currency positions were excluded from exposure calculations. The adviser and it principal were censured, agreed to a cease-and-desist order, and agreed to pay civil penalties and disgorgement (with interest), totaling to approximately $3.2 million.

Final Share Class Selection Disclosure Initiative cases and more to come

On April 17, the SEC announced that it had settled charges against two more investment advisers in connection with its Share Class Selection Disclosure Initiative, and settled charges against a third adviser that self-reported within months of this Initiative's self-reporting deadline.[3] Importantly, the SEC noted that these would be the final cases the SEC's Enforcement Division intends to recommend under the terms of the Initiative.

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[2] *In re* Everest Capital LLC, Admin. Pro. No. 3-19777 (April 30, 2020).

[3] Admin. Pro. No. 3-19752(April 17, 2020), Admin. Pro. No. 3-19753 (April 17, 2020), and Admin. Pro. No. 3-19755 (April 17, 2020).

The Initiative, which was announced on February 12, 2018, gave investment advisers an opportunity to self-report that they had failed to fully and fairly disclose conflicts of interests in selecting for their advisory clients more expensive mutual fund share classes that paid 12b-1 fees when lower-cost share classes were available for the clients. Self-reporting advisers were eligible for standard settlement terms that did not include the imposition of a civil penalty.

In announcing these cases, the co-chief of the SEC's Asset Management Unit cautioned that the SEC staff will "continue to actively pursue disclosure failures that financially benefit the adviser to the detriment of the client." Shortly thereafter, on April 24, the SEC announced an enforcement action against an investment adviser demonstrating the SEC's continued focus on conflicts over fund fees.[4] In that case, the SEC alleged that an SEC-registered investment adviser and broker-dealer recommended and sold retail retirement account and charitable organization brokerage customers more expensive mutual fund share classes when less expensive share classes in the same funds were available. Unlike self-reporting advisers under the Initiative, the adviser in this case agreed to pay a penalty under the terms of the SEC settlement. The adviser consented to cease-and-desist, was censured, and paid disgorgement of $2,607,676, with prejudgment interest of $631,331, and a civil penalty of $650,000.

Alleged Mispricing of Odd Lots and Misleading Performance

On April 28, the SEC sued a registered investment adviser for allegedly misleading investors about the performance of a mutual fund and causing odd lot bonds (i.e., small-sized pieces with less than $1 million current face value) in the fund's portfolio to be overvalued.[5] According to the SEC order, for approximately 10 months after the fund commenced operations as part of a strategy to diversify the fund's portfolio, the fund's investments consisted almost entirely of odd lot bond positions in non-agency mortgaged back securities.

The SEC noted that odd lot positions typically trade at a discount to round lot (or institutional sized) positions. After the fund purchased these odd lot bonds, third-party vendors provided prices for these odd lot bonds that reflected institutional round lots pricing. For example, if an odd lot was bought for a price of 97, it would be priced by the third party right after purchase at the higher round lot price of 100 or so. As a result, the fund's performance reported at the end of the trading day got a "bump" in performance — the fund's performance increased as a result of the difference between the purchase price for the odd lot position and the higher round lot price used to value the position. According to the SEC, from July 22, 2013 to May 31, 2014, the reported performance of the fund benefited from the mark-up of 126 odd lot positions to round lot prices, increasing the valuation of the odd lots by 3.5%, on average, over its purchase price.

The SEC alleged that the investment adviser did not have a reasonable basis to believe that the institutional price used by the fund "accurately reflected the price that [the fund] would receive for these positions in a current sale", as required under SEC rules and the fund's valuation policies. (Importantly, as noted in the SEC order, "depending on the circumstances, it is not necessarily improper to value an odd lot position at a [round lot price]".) Despite this, according to the SEC, the adviser "caused" the round lot prices to be used to value odd lot positions. The SEC order stated that the adviser was responsible for providing "input" to, and had the ability to question pricing determinations made by, the fund's valuation committee. This valuation committee was made up of representatives of the fund's third party administrator and the fund's board of directors.

The SEC's order stated that the fund's 2013 and 2014 annual reports to investors did not disclose that the fund's investment performance had been materially improved by the overvaluation of odd lot bond positions. Instead, the investment adviser "misleadingly attributed the performance to, among other things, [the adviser's] purchase of non-agency mortgage backed securities that rose towards fundamental values during the periods in question."

4 Admin. Pro. No. 3-19769 (April 24, 2020).

3 *In re* Semper Capital Management, L.P., Admin. Pro. No. 3-19773 (April 28, 2020).

As a result of, among other things, the overvaluations of odd lots causing the fund's net asset value to be overstated and the adviser's failure to disclose to investors that the adviser's valuation practices for odd lot positions in bonds were a material contributor to the fund's performance, the SEC's order found that the adviser willfully violated Section 206(4) of the Investment Advisers Act of 1940 and Rules 206(4)-7 and 206(4)-8 thereunder and Section 34(b) of the Investment Company Act of 1940, and that the adviser caused the mutual funds uncharged violation of Rule 22c-1 thereunder. The adviser agreed to a cease-and-desist order, a censure and payment of disgorgement of advisory fees totaling $103,228, plus interest of $25,000, and a $375,000 penalty.

This case demonstrates the SEC's continued focus on valuation matters and disclosures made to investors, particularly disclosures around a fund's performance. Advisers should consider reviewing their performance reporting and pricing policies to make sure these policies, among other things, specify who has responsibility for statements around performance attribution and adequately address and document pricing challenges and coordination with fund administrators.

Conclusion

Advisers need to proactively evaluate potential conflicts of interests in their business practices and review their disclosures in light of these practices. This includes continuing to review closely how even minor costs are allocated and charged to funds they manage, and documenting the decisions around the amount and type of work performed and cost allocations. Finally, and perhaps most importantly, most of the enforcement actions against private fund managers alleged that the firms had inadequate policies and procedures. Firms should develop, implement and continually revise, as necessary, detailed policies and procedures to regulate their operations.

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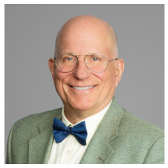

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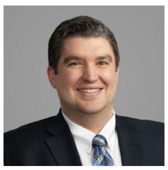

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