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SEC Settlements Highlight Governing Document Amendment Considerations for Private Funds

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Limited partnership agreements and similar documents that govern private funds are often amended over the course of a fund's life cycle. For example, many funds may be currently going through the amendment process in connection with the upcoming effective date of the Private Fund Adviser Rules.[1] We want to remind fund managers of certain (maybe not so obvious) considerations to keep in mind when preparing to amend or proposing amendments to their fund governing documents. To do so, we have examined two settlements with the U.S. Securities and Exchange Commission (SEC).

Background

Generally, governing documents have an "amendment" section that governs how they may be amended (e.g., what threshold vote of limited partners, if any, is required to amend). While managers should always comply with the respective governing document's amendment requirements, there are other factors to consider, particularly when it comes to disclosing conflicts of interest. Below we examine two SEC settlements that make clear that the amendment section of a governing document provides a floor rather than a ceiling for a manager's obligations and duties and that managers may be required to do more than what is required under a respective governing document's amendment provision.

Fully Informed Consent

In 2023, the SEC settled with a fund manager who, among other things, failed to disclose material facts and conflicts of interest when proposing governing document amendments to investors in their funds.[2] In this situation, the settlement notes the manager, who was separately a co-creator of a holding company with the purpose of operating in California's marijuana industry, engaged in fraudulent offerings that resulted in the enrichment of outside investors who had not made capital contributions to the fund in question. The manager then transferred hundreds of thousands of dollars of fund assets to the above-mentioned holding company for "management expenses." The manager later proposed an amendment to the fund's governing document that would grant profit interests in the fund to outside investors who had invested in the marijuana venture but had not made capital contributions to the fund. The manager, when proposing the amendment, did not inform fund investors that outside investors would be sharing in the profits of the fund. Rather:

> In seeking the limited partners' consent to the proposed amendment, [the manager] failed to disclose anything about the syndicate investors, including the effect of granting them profit interests. Instead, [the manager] falsely stated that the requested amendment to the [governing document] was necessary due to [other reasons]. [The manager] also falsely stated that the amendment would not "hurt" or "disadvantage" any limited partner in [the fund], when, in fact, the limited partners who contributed cash in exchange for their LP [i]nterests were hurt and disadvantaged since they became obligated–via the requested amendment–to share [the fund's] profits with the converted syndicate investors.

The settlement notes that this series of events violated several sections of the Securities Exchange Act and the Investment Advisers Act. While the settlement implies some intentionality on the part of the manager, it should still serve as an example of why the reasons for governing document amendments must be fully, fairly, and accurately disclosed. However, as noted below, this was not a case of first impression.

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[1] *See* e.g., https://www.lowenstein.com/news-insights/publications/client-alerts/the-sec-s-private-fund-adviser-rules-explained-part-1-the-restricted-activities-rule-im.
[2] https://www.sec.gov/files/litigation/admin/2023/33-11160.pdf.

Not-So-Unilateral Unilateral Amendments

In a 2014 settlement,[3] the SEC describes a scenario where certain private funds had insufficient cash to pay expenses but were not permitted under their governing documents to borrow money or issue promissory notes (which would have been used to cover expenses). The settlement explains that the manager unilaterally amended the governing documents to permit borrowing and then made loans to the funds, without disclosing to the investors (a) information about the loans, (b) that fund assets would be pledged as collateral, or (c) the existence of the amendments themselves. Notwithstanding the fact that the manager may have ostensibly been permitted to unilaterally amend the governing documents pursuant to the amendment provision, the SEC took issue with these actions, noting that "even if the governing documents had permitted such unilateral amendments, [the manager], as the holder of the notes and security interest, had a conflict of interest and could not consent to the loans and pledges on behalf of the [funds] without adequate disclosure to the investors." The SEC also noted these transactions were "principal transactions" under Rule 206(3) and the manager did not comply with the requirements thereunder.[4]

Takeaways

These settlements serve as a cautionary tale and highlight the importance of full transparency when proposing governing document amendments. Managers must clearly describe and disclose any conflicts of interest related to such amendments. Further, managers must be aware that even if an amendment provision permits unilateral amendment, the manager still may be unable to do so when any such conflict is present. Managers often believe that the only steps they need to take in making an amendment to a governing document is by following the relevant amendment provision. However, managers must take into consideration any potential conflicts of interest outside the scope of their governing documents and ensure they make full and accurate disclosures when proposing any amendments.

Next Steps

For further information, guidance, and clarity on how advisers can approach, tailor, and draft governing document amendments (including, but not limited to, the disclosure related thereto), please reach out to the authors of this article or to your regular Lowenstein Sandler contact directly.

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[3] https://www.sec.gov/files/litigation/admin/2014/33-9667.pdf.
[4] *See* e.g., https://www.lowenstein.com/news-insights/publications/client-alerts/sec-identifies-common-principal-and-agency-cross-trading-compliance-deficiencies-investment-management.

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