Lowenstein Sandler

Client Alert

Investment Management

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Two Recent SEC Enforcement Actions Against Registered Investment Advisers Underscore That Regulatory Compliance Is Still Relevant Despite Enforcement Priority and Examination Changes

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In the first half of August, the U.S. Securities and Exchange Commission (SEC) announced settlements with two different registered investment advisers for violations of the Investment Advisers Act of 1940. Specifically, on August 1, the SEC found an investment adviser (Adviser 1) to be in violation of Rule 206(4)-2 (the Custody Rule),[1] and on August 15, it found a different investment adviser (Adviser 2) to be in violation of Rule 206(2), which prohibits advisers from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[2] The settlements with these two registered investment advisers resulted in a $50,000 civil penalty for Adviser 1 and a $175,000 civil penalty and $500,000 in disgorgement for Adviser 2. These recent enforcement actions underscore the SEC's commitment to bringing enforcement actions for certain compliance violations, despite the recent deregulation push and change in enforcement priorities.

Adviser 1 Settlement

In its August 1 enforcement action, the SEC found that Adviser 1 failed to comply with the Custody Rule for more than six years prior to enforcement.[3] The case arose not from allegations of fraud or client harm but from Adviser 1's ongoing ability to exercise authority over client accounts in ways that triggered the Custody Rule. From 2018 through 2024, the adviser's president and chief compliance officer served as co-trustee for two advisory client trusts. The trust agreements granted each co-trustee "broad investment and other powers" under the agreements and applicable law, including the authority to trade, buy, sell, or otherwise acquire and dispose of securities and other investments, as well as broad borrowing and credit powers. The agreements allowed each co-trustee to act independently, meaning the president of Adviser 1 could direct transactions and transfers from the trusts' accounts without the consent of the other co-trustee. Under the Custody Rule, this independent authority constituted custody because it gave Adviser 1 the ability to access or obtain possession of client funds and securities.[4]

In addition to his trustee roles, the president held signatory authority for four client accounts, with the same capacity to instruct the broker as the accounts' beneficial owner, and acted under powers of attorney on five more client accounts. These powers of attorney included the authority to make disbursements or transfers, including to himself, without restriction.

As these arrangements gave Adviser 1 "custody" of the investor assets within the meaning of the Custody Rule, Adviser 1 was required, among other things, to engage an independent public accountant to perform annual surprise examinations of the client accounts.[5] It failed to do so at any point during the relevant period, resulting in a $50,000 civil penalty and a cease and desist order. This settlement demonstrates that the SEC will bring enforcement actions where an adviser's authority over client funds meets the regulatory definition of "custody," even if such authority is never misused and/or the adviser did not intend to assume custody. Notably, the settlement involved a relatively modest penalty and did not include additional charges such as inadequate policies and procedures under Rule 206(4)-7.

Adviser 2 Settlement

On August 15, the SEC entered into a settlement with an investment adviser for breaching its fiduciary duty between 2018 and 2023 regarding management fee calculation practices related to compensation that the investment adviser received from portfolio companies.[6] Adviser 2 was entitled to both management fees from each of the private funds it advised and transaction fees from the managed portfolio companies. The transaction fees include, among others, transaction, advisory, and monitoring fees. However, under the fund partnership agreements, Adviser 2 was required to credit back to each of the advised funds a portion of the transaction fees from the portfolio companies to offset the management fee owed by the applicable fund. In the applicable period, Adviser 2 engaged in two fee offset calculation practices that the settlement order stated created a conflict of interest and that were not properly disclosed to the relevant funds.

First, for five of the managed portfolio companies, the management services agreement between Adviser 2 and the portfolio company allowed for payment of the transaction fees to be deferred at the adviser's discretion. The managed services agreement contained provisions that described types of compensation that Adviser 2 could have excluded from the management fee offset, but interest on the applicable deferred transaction fees was not listed among the exclusions. Despite these fees not being excluded during the relevant period, Adviser 2 collected interest on such deferred transaction fees from these portfolio companies and did not include that interest in the offset calculation. This resulted in the funds ultimately receiving lower fee offsets than they were entitled to and Adviser 2 did not disclose to the funds that it collected interest and did not include the interest in the corresponding fee offsets.

Second, for one portfolio company in which multiple funds invested, Adviser 2 started with a reduced allocation of transaction fees to each investing fund, resulting in lower fee offsets and a larger management fee to the investment adviser. The fund agreements provided that each fund's fee offset should have been calculated based on *all* transaction fees that the investment adviser received from the portfolio company and that each fund's allocation of these transaction fees would be reduced based on the other funds' *fully diluted equity ownership* in the portfolio company. Instead, Adviser 2 allocated to each fund a portion of the transaction fees received based on each fund's *pro rata* share and then reduced each fund's allocation a second time based on each fund's fully diluted equity ownership of the portfolio company.

Due to the foregoing withholding of the funds' offsets, the settlement order stated that the investment adviser charged the funds over $500,000 in excess management fees. The settlement order went on to state that Adviser 2's conduct during the applicable period was in violation of Rule 206(2), which prohibits registered investment advisers from engaging in a course of business that defrauds or deceives a client. Adviser 2 agreed to cease and desist the activity and pay (1) over $500,000 in disgorgement and interest directly to the funds and (2) a $175,000 civil fine.

Takeaways

Despite the recent deregulation push, focus on cryptocurrency and artificial intelligence, and change in the SEC's enforcement tactics away from "regulation by enforcement," these recent investment adviser settlements indicate that the SEC is still pursuing certain regulatory compliance violations. The compliance violations described above (i.e., custody, conflicts of interest, and fee calculations) have also been pursued by enforcement in prior administrations.[7]

However, the settlements also highlight a pivot in the SEC's enforcement approach. For example, both cases limited the charges to the predicate offense without additional charges such as inadequate policies and procedures. As noted above, the Custody Rule case in particular had a relatively low civil penalty; further, neither case involved a claim of an intentional violation of law nor named any natural persons as defendants. However, in the Adviser 2 case, even though the civil penalty was under $200,000, the disgorgement remedy required the adviser to return funds to investors, which necessitates an explanation as to why the funds are being returned.

These cases underscore that investment advisers cannot afford to neglect their compliance obligations, policies, and procedures in place to prevent misconduct, despite the push for deregulation. Clearly, the SEC will continue to pursue compliance violation cases against investment advisers without a finding of actual fraud or misappropriation, even if charges and penalties are more limited than seen in prior administrations.

Additionally, in each enforcement action, the investment adviser's agreements and fund documents controlled the investment adviser's course of action. A careful review of all agreements and documentation of the funds under management is important to cross-reference with the investment adviser's internal policies and procedures.

Next Steps

For further information about the recent enforcement actions or questions pertaining to investment adviser regulatory compliance, policies, and procedures, please reach out to the authors of this article or to your regular Lowenstein Sandler contact directly.

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[1] 17 C.F.R. § 275.206(4)-2(d)(2).
[2] 17 C.F.R. § 275.206(2).
[3] *See* "In the Matter of Munakata Associates LLC," SEC Administrative Proceeding File No. 2-33500.
[4] *Id*. at 1.
[5] 17 C.F.R. § 275.206(4)-2(a)(1)-(4).
[6] *See* "In the Matter of TZP Management Associates, LLC," SEC Administrative Proceeding File No. 3-22511.
[7] *See, e.g.,* https://www.lowenstein.com/news-insights/publications/articles/slew-of-recent-sec-enforcement-actions-guidance-for-registered-investment-advisers-october-2023-moss-goret-zadourian-lipton; https://www.lowenstein.com/news-insights/publications/client-alerts/another-wave-of-sec-settlements-underscore-the-continued-priority-of-record-retention-communication-compliance-im; https://www.lowenstein.com/news-insights/publications/client-alerts/sec-settles-against-nine-investment-advisers-for-marketing-rule-violations-underscoring-the-continued-priority-of-marketing-rule-compliance-im.

Contacts

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