

SEC Brings Strategy Drift Enforcement Action Against Registered Advisers

The SEC recently settled an enforcement action against two affiliated registered investment advisers based on failing to disclose the advisers' change in investment strategy for a registered fund.

According to the SEC consent order, the advisers managed a fund primarily investing in distressed debt with a strategy focused on purchasing debt holdings expected to increase in value. This strategy was reflected in offering materials, SEC filings and investor communications. Later, the advisers changed course and began investing primarily in credit default swaps, a strategy expected to produce returns through debt holdings decreasing in value. This shift to credit default swaps "dramatically changed the fund's risk profile," according to the SEC, and contributed to the fund incurring significant losses. The fund ultimately liquidated. From the fund's change in principal investment strategy through liquidation, the fund's investment strategy and its risks were, according to the SEC, inaccurately represented in SEC filings and in various communications to investors, prospective investors and the fund's board of directors.

Pursuant to the consent order, the advisers agreed to pay a \$3 million civil penalty, plus prejudgment interest, and over \$13 million to investors, comprised of disgorgement of revenue during the period after the unannounced shift in strategy occurred, plus interest, and "losses" to investors (calculated as the difference between the actual investment performance of the fund and the hypothetical investment performance of the fund's investment portfolio had the portfolio been managed in accordance with the disclosed strategy instead of the modified strategy).¹

Registered investment advisers, including advisers to private funds, should be aware of the SEC's examination and potential enforcement focus on style drift from investment strategies stated in offering materials, investor communications and SEC filings.²

¹ The SEC found, among other violations, that the fund's advisers violated the antifraud provisions of Section 206(4) of the Advisers Act and Rule 206(4)-8, which make it unlawful for any fund adviser to make any false or misleading statement of material fact to any fund investor or prospective investor or to engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any fund investor or prospective investor.

² Advisers to registered or other open-end or periodically offered funds should review their risk and investment strategy disclosure on a regular basis to ensure it comports with actual practice.

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