SEC Settles with Affiliated Advisers and their Principal/CCO over Registration and Other Practices

The SEC recently settled a proceeding against two affiliated investment advisers related to the failure to register an investment adviser to two private funds and a number of other practices (discussed below), which were inconsistent with the advisers' obligations under the Advisers Act. The settlement also named the advisers' principal, sole owner and Chief Compliance Officer (the "Principal"). The consent order reflects the SEC's continued focus on private fund managers' practices and compliance with the Advisers Act, including through enforcement actions.[1] According to the consent order:

- *Failure to Register Affiliated Adviser*. The Principal operated a SEC-registered adviser, advising primarily individuals. The Principal then formed a separate entity to advise two private funds with approximately $11 million in combined assets, purporting to operate the private fund adviser out of the Principal's home and, therefore, separate from its affiliated registered investment adviser entity. The Principal claimed that the private fund adviser was not required to register under the Advisers Act due to the exemption available for advisers solely to private funds with regulatory assets under management of less than $150 million or required to comply with the Custody Rule's annual fund audit and other Advisers Act requirements applicable to registered advisers. The SEC maintained that because both advisory entities were under common control and operationally integrated, both entities were required to be registered with the SEC and fully comply with the Advisers Act.[2]

- *Valuation Issues*. The private fund adviser was required to value a private fund's illiquid private investments at fair value under the fund's operating agreement. However, the private fund adviser provided multiple statements to fund investors reflecting inflated and/or stale investment values and did not maintain valuation policies, in violation of the Advisers Act.[3]

- *Failure to Comply with Custody Rule*. The private fund adviser did not subject its private funds to an annual GAAP audit or obtain a surprise custody examination for several years, as required under the Advisers Act's Custody Rule. Further, the registered adviser did not maintain certain client assets with a qualified custodian, had access to certain clients' accounts and did not obtain surprise custody examinations for a five-year period.

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- *Compliance Program Deficiencies*. Although the advisers worked with a compliance consultant to adopt an off-the-shelf compliance manual, the manual was not tailored to the types of business the advisers conducted and was not annually reviewed for adequacy and effectiveness. The advisers also failed to adopt or implement policies and procedures addressing the valuation of fund assets or addressing the registration requirements, or exemptions from registration available, under the Advisers Act (discussed above).

- *Failure to Qualify Investors Subject to Performance Fees*. The private fund adviser was authorized to receive performance fees under a private fund's operating agreement. However, not all investors in the fund were "qualified clients," as required by the Advisers Act, and the private fund adviser had not conducted a review to determine if each investor was a qualified client.[4]

- *Private Fund Expense Practices*. A private fund's assets were used to pay approximately $65,000 in legal costs incurred in connection with the SEC's investigation of the advisers and the Principal; however, such costs were not permitted to be charged to the fund under its governing documents.

The SEC required that the advisers and the Principal pay a civil money penalty of $150,000. The SEC also limited the Principal from serving in a CCO capacity with any investment adviser or certain other designated financial industry entities for three years, after which the Principal may reapply to act in such capacity. Further, the SEC required the Principal to undertake Advisers Act compliance training and required the advisers to retain an independent compliance consultant.

In light of the SEC's ongoing and detailed focus on private fund managers for compliance with the Advisers Act, managers should continue to review their practices against their Advisers Act obligations.

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1 While SEC officials have recently indicated that the agency may focus more on protecting retail investors under the current administration, the specialized examination teams in the Private Funds Unit of the SEC's Office of Compliance Inspections and Examinations (OCIE) will continue to examine the practices of private fund managers.

2 Under the SEC's *Richard Ellis* doctrine, two or more affiliated advisers may be combined when considering whether each adviser must register under the Advisers Act unless each adviser is sufficiently independent of the other. For managers to private funds, generally it is permissible to register affiliated advisers through a single private fund adviser's Form ADV.

This is the SEC's first integration proceeding since *In the Matter of TL Ventures Inc.* and *In the Matter of Penn Mezzanine Partners Management, L.P.* (June 20, 2014), where the SEC sought to monitor reliance on the new private fund exemptions created by the Dodd-Frank Act. Similar to this proceeding, in those proceedings the SEC concluded that the two affiliated advisers (TL Ventures and Penn Mezzanine) were operationally integrated and, as a result, unable to qualify for any exemption from registration under the Advisers Act.

3 The consent order noted, however, that the private fund adviser did not receive any fees based on the inflated valuations.

4 The consent order noted that, as of the date thereof, performance fees had not been charged.

If you have any questions about the matters addressed in this *Kirkland AIM*, please contact the following Kirkland attorneys or your regular Kirkland contact.

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The Legal 500 US, 2017

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