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WEIL PRIVATE FUNDS REGULATORY REVIEW

In recent years, the Securities and Exchange Commission (the "**SEC**" or "**Commission**") and other regulators have proposed and adopted, and continue to propose and adopt, various rules and changes to the regulatory landscape of private funds and their advisers. This publication discusses (i) the upcoming deadline for US domestic and foreign companies required to file beneficial ownership information reports under the Corporate Transparency Act ("**Reporting Companies**");[1] (ii) the recent rule promulgated by the US Department of the Treasury's Financial Crimes Enforcement Network ("**FinCEN**") that applies anti-money laundering/countering the financing of terrorism ("**AML/CFT**") requirements to certain registered investment advisers and exempt reporting advisers;[2] and (iii) the recent SEC FAQ concerning the amendments to Form PF adopted on February 8, 2024.[3]

The SEC's Division of Enforcement recently closed out a very active year by bringing a wide variety of actions against private fund sponsors and their affiliates. This publication discusses the SEC's recent settlements of charges against: (i) an exempt reporting adviser for failure to register with the SEC as an investment adviser as a result of integration with its affiliate, and for the resulting failure to comply with Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**"); (ii) a registered investment adviser for failing to implement written compliance policies and procedures to oversee its relying advisers; (iii) several investment advisers in connection with the SEC's ongoing sweep into violations of Rule 206(4)-1 under the Advisers Act (the "**Marketing Rule**"); (iv) registered investment advisers and others for impeding advisory clients from reporting securities law violations to the SEC; (v) a registered investment adviser for including impermissible liability disclaimers in its advisory and private fund agreements; (vi) registered investment advisers for failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information ("**MNPI**"); (vii) formerly registered investment advisers related to violations under the Custody Rule; (viii) registered investment advisers concerning the use of affiliated service providers; (ix) a registered investment adviser for violations of Rule 206(4)-5 under the Advisers Act (the "**Pay-to-Play Rule**"); (x) several broker-dealers, investment advisers, and dually-registered broker-dealers and investment advisers for failures by the firms to maintain and preserve electronic communications; and (xi) registered investment advisers related to the failure to disclose certain conflicts of interest.

1 The Corporate Transparency Act was passed by Congress as part of the Anti-Money Laundering Act of 2020. The full text of FinCEN's final rule can be found here. A previous alert discussing the final rule can be found here.

2 A press release and fact sheet related to the rule can be found here and here, respectively. The rule's adopting release can be found here.

3 A link to the FAQ can be found here. The full text of the amendments' adopting release can be found here, and a related fact sheet can be found here.

REGULATORY ROUND-UP

CORPORATE TRANSPARENCY ACT JANUARY 1, 2025 FILING DEADLINE

As a reminder, under the Corporate Transparency Act, Reporting Companies existing prior to January 1, 2024 have until January 1, 2025 to file an initial beneficial ownership information report. Reporting Companies formed or registered to do business in the US on or after January 1, 2024 but before January 1, 2025 are required to submit an initial report within 90 days of being formed or registered. Finally, Reporting Companies formed or registered to do business in the US after January 1, 2025 will be required to submit an initial report within 30 days of being formed or registered.

FINCEN ISSUES FINAL RULE TO COMBAT ILLICIT FINANCE AND NATIONAL SECURITY THREATS IN THE INVESTMENT ADVISER SECTOR

On August 28, 2024, FinCEN issued a final rule to help safeguard the investment adviser sector from illicit finance activity, including misuse by criminals, foreign adversaries and other money laundering and terrorist financing threats.

The final rule adds to the definition of "financial institution" under the regulations that implement the Bank Secrecy Act (the "**BSA**") (i) investment advisers registered with or required to register with the SEC ("**RIAs**") and (ii) investment advisers that report information to the SEC as exempt reporting advisers ("**ERAs**").

The final rule requires covered advisers to:

i. implement a risk-based and reasonably designed AML/CFT program;

ii. file certain reports, such as Suspicious Activity Reports, with FinCEN;

iii. keep certain records, such as those relating to the transmittal of funds; and

iv. fulfill certain other obligations applicable to financial institutions subject to the BSA and FinCEN's implementing regulations, such as special information sharing procedures.[4]

While the compliance date for the final rule is January 1, 2026, it is important for advisers, particularly standalone advisers that do not have affiliated broker-dealers, to begin preparing for the new rules as soon as possible. Developing a tailored program, including training staff, identifying red flags and filing Suspicious Activity Reports, will be a significant undertaking for advisers who do not have experience with operating an anti-money laundering program.

In addition, while an anti-money laundering program will be new to investment advisers, FinCEN delegated authority to examine and enforce this anti-money laundering rule to the SEC. The SEC has decades of experience enforcing anti-money laundering requirements for broker-dealers, and it is unlikely that SEC examination staff will face the usual learning curve that typically accompanies new rules.[5]

SEC RELEASES RESPONSES TO FREQUENTLY ASKED QUESTIONS REGARDING FORM PF AMENDMENTS

On October 4, 2024, the SEC released responses to frequently asked questions concerning the amendments to Form PF adopted on February 8, 2024. The SEC clarified that any Form PF filing made on or after the March 12, 2025 effective date of the amendments must be on the amended version of the form. So, to the extent an annual filer with a calendar year-end—whose annual update would be due by April 30, 2025—submits the annual update on or after March 12, 2025, the filer would be required to use the amended form. However, a quarterly filer with a calendar year-end—whose quarterly filing for the quarter-ended December 31, 2024 would be due before March 12, 2025—would not be required to use the amended form until the filing for the quarter-ended March 31, 2025.

Lastly, the SEC also clarified that all filers are required to transition to calendar quarterly reporting for the quarter-ended June 30, 2025, and a quarterly report on the amended form must be filed by August 29, 2025. Thus, for a quarterly filer whose fiscal year ends on January 31, 2025, such filer is required to file a quarterly report by April 1, 2025. If filed on or after March 12, 2025, the filing must be made on the amended Form PF. The filer would then transition to calendar quarter-end reporting, with the next report due by August 29, 2025.

4 On May 13, 2024, the SEC and FinCEN jointly proposed (but have not yet adopted) a new rule that would require RIAs and ERAs to establish, document and maintain written customer identification programs ("**CIPs**"). The rule, if adopted, would require RIAs and ERAs to, among other things, implement a CIP that includes procedures for verifying the identity of each customer to the extent reasonable and practicable and for maintaining records of the information used to verify a customer's identity. A press release and fact sheet related to the proposed rule can be found here and here, respectively.

5 A risk alert discussing the SEC's observations arising from conducting anti-money laundering compliance examinations of broker-dealers can be found here.

NOTABLE ENFORCEMENT ACTIVITY

ENFORCEMENT ACTION RELATED TO INTEGRATION OF ADVISERS

On September 20, 2024, the SEC announced that it settled charges with an exempt reporting adviser for failing to register as an investment adviser and for Custody Rule violations stemming from its failure to register.[6] Between November 2018 and January 2023, the adviser took the position that it qualified for an exemption from registration available to investment advisers that manage only private funds with assets under management of less than $150 million.

However, the SEC found that the adviser did not, in fact, qualify for this exemption because there was "operational and ownership overlap" between the adviser and its affiliate, which was a registered investment adviser. According to the Order, the adviser and the affiliated registered investment adviser shared overlapping owners, executives and investment advisory personnel. The firms also shared an office, email domains and IT systems. Moreover, there were no policies or related procedures to keep the firms separate from one another or to protect investment advisory information of one entity from disclosure to the other.

In interpreting Section 208(d) of the Advisers Act, the SEC has stated that it will treat as a single adviser two or more affiliated advisers that "are separate legal entities but are operationally integrated, which could result in a requirement for one or both advisers to register." In light of the facts above, the SEC determined to integrate the two advisers, and as a result, the exempt reporting adviser was required to register with the SEC. The adviser was alleged to have violated the Custody Rule, applicable to registered investment advisers, because it had custody of client assets and failed to obtain an annual audit or surprise examinations, as required by the Rule. In response to this settlement, advisers should carefully monitor their interactions with affiliates to prevent operational integration from triggering a potential registration requirement.

ENFORCEMENT ACTION RELATED TO FAILURE TO SUPERVISE RELYING ADVISERS

On September 20, 2024, the SEC announced that it settled charges against a registered investment adviser for failing to implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act.[7] According to the Order, from December 2018 until May 2022, the adviser failed to conduct (i) compliance training for all supervised persons, (ii) spot-checks of books and records, and (iii) periodic inspections of the principal place of business of its relying advisers, all of which were required by the adviser's compliance policies.

As a result of this conduct, the adviser was alleged to have violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder by the adviser and its supervised persons. In response to this settlement, advisers should ensure that they have implemented their written compliance policies and procedures in practice, particularly with respect to the supervision of relying advisers.

MARKETING RULE ENFORCEMENT ACTIONS

On September 9, 2024, the SEC announced that it settled charges against nine registered investment advisers for violating the Marketing Rule.[8] Among other things, the Orders alleged that two of the advisers violated the Marketing Rule by including untrue statements about third-party ratings in their advertisements, while three of the advisers failed to disclose the dates on which the third-party ratings (some of which were more than five years old) were given or the periods of time on which the ratings were based, as required by the Marketing Rule. Four of the advisers were alleged to have included in their advertisements that the advisers provided conflict-free advisory services, which the firms were unable to substantiate. Another adviser advertised endorsements but failed to disclose that the endorser was a paid non-client of the adviser.

These settlements reflect the SEC's continued intense focus on the Marketing Rule, particularly with respect to substantiation, disclosure and third-party ratings. In response to these settlements, advisers should ensure that they are able to substantiate all material facts included in their advertisements. Advisers should carefully review their advertisements to ensure that the required disclosure accompanies all third-party ratings, testimonials and endorsements.

Additionally, on August 9, 2024, the SEC announced that it settled charges with a registered investment adviser for violating the Marketing Rule.[9] From the November 4, 2022 effective date of the Marketing Rule, through December 15, 2023, the adviser posted quarterly performance reports on its public website which contained hypothetical performance. According to the Order, in connection therewith, the adviser failed to implement policies and procedures reasonably

6 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

7 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

8 A press release, along with links to the respective SEC Orders, can be found here.

9 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

designed to ensure that this advertised hypothetical performance was relevant to the likely financial situation and investment objectives of the intended audience of the advertisement, in violation of Section 206(4) of the Advisers Act and Rule 206(4)-1(d) thereunder.

This settlement emphasizes the SEC's continued focus on the presentation of hypothetical performance in advertisements. In response, advisers should review their internal policies and procedures and make sure that they contain a process for ensuring that any advertised hypothetical performance is relevant to the likely financial situation and investment objectives of the advertisement's intended audience.

WHISTLEBLOWER PROTECTION ENFORCEMENT ACTIONS

On September 26, 2024, the SEC announced that it settled charges against a registered investment adviser for entering into agreements with candidates for employment and a former employee that encumbered the ability of the individuals to report potential securities law violations to the SEC.[10]

According to the Order, from November 2020 through September 2023, the adviser asked certain employment candidates to sign non-disclosure agreements that prohibited them from disclosing to government agencies confidential information about the adviser. Although the agreements permitted the candidates to respond to requests for information from the SEC, they required notification to the adviser of any such requests and prohibited the candidates from responding to requests arising from such candidate's voluntary act of disclosure.

The adviser also entered into an agreement with a former employee whose counsel informed the adviser that she intended to report alleged securities law violations to the SEC. Although the agreement carved out from its confidentiality provisions the reporting of potential securities law violations, it also required the former employee to represent that she (i) had not sought to initiate any investigation by any government agency, (ii) was aware of no facts that would form the basis of any such investigation and (iii) would withdraw any statements already made that would form the basis of an investigation. For this conduct, the adviser was charged with violating the whistleblower protections afforded under Securities Exchange Act of 1934 (the "**Exchange Act**") Rule 21F-17(a).[11]

In addition, on September 4, 2024, the SEC announced that it settled charges against a registered investment adviser, along with its affiliated registered broker-dealer and state-registered investment adviser for similar conduct.[12] From May 2021 through February 2024, the various parties asked brokerage customers and advisory clients to sign confidentiality agreements which contained provisions expressly limiting a client's ability to voluntarily report potential securities law violations to the SEC, with only a limited carve-out for responding to unsolicited requests for information from government entities and self-regulatory organizations that oversee the advisers and their employees. Many agreements also contained a provision which required clients to affirmatively certify that they had not previously, nor would they ever, voluntarily report information regarding the subject matter of the agreement to the SEC. The firms were likewise charged with violating Rule 21F-17(a).

These settlements reflect the SEC's continued focus on whistleblower protection. In particular, advisers should avoid including in agreements confidentiality provisions that create the impression that parties to the agreement are prohibited from reporting potential securities law violations to the SEC or are permitted to report potential violations only when initiated by the SEC. Moreover, even agreements that permit reporting of potential violations can be problematic to the extent the agreement contains restrictive language elsewhere that "impedes voluntary reporting" to the SEC.

ENFORCEMENT ACTION RELATED TO LIABILITY DISCLAIMER VIOLATIONS

On September 3, 2024, the SEC announced that it settled charges against a registered investment adviser for, among other violations, its use of improper liability disclaimer language, commonly referred to as a hedge clause, in its advisory agreements and in private fund partnership and operating agreements.[13]

From at least 2019, the adviser used in its partnership agreements hedge clauses that purported to broadly limit the adviser's liability. The hedge clauses set forth that the adviser was not liable to its private fund clients for "mistakes of judgment, or for action or inaction" and explicitly required investors to "waive[] any and all current and future claims (and right to assert such claims) against [the adviser] and other Indemnified Partners for any breach of fiduciary duty."

10 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

11 Rule 21F-17(a) provides that no person may take any action to impede an individual from communicating directly with the SEC Staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement (subject to certain exceptions) with respect to such communications.

12 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

13 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

The Order provided that the hedge clauses utilized by the adviser, when read in their entirety, were inconsistent with the adviser's fiduciary duty because they may have misled the adviser's clients into not exercising their non-waivable legal rights, and as such, the adviser was charged with violating Section 206(2) of the Advisers Act.[14] In response to this settlement, advisers should carefully review the indemnification and exculpation provisions in their agreements and ensure they are not overly broad and that they contain language that appropriately limits the scope of any liability waiver.

ENFORCEMENT ACTIONS RELATED TO POLICIES AND PROCEDURES AROUND MNPI

On September 30, 2024, the SEC announced that it settled charges against a registered investment adviser for failing to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI relating to its participation on ad hoc creditors' committees.[15] Due to the nature of the adviser's business, the adviser regularly engaged with investors and/or financial advisers seeking to form ad hoc committees of creditors in order to group large creditors with similar interests together in order to explore potential restructuring opportunities for an issuer. In the course of participating in such committees, the adviser interacted with financial advisers who had access to MNPI regarding various issuers.

According to the Order, while the adviser had general policies and procedures for evaluating and handling MNPI, they were not reasonably designed to address the risks specifically related to the potential for receipt, including the inadvertent receipt, and misuse of MNPI resulting from participation in the creditors' committees. Specifically, there were no policies or procedures for the adviser's employees to conduct due diligence concerning the financial advisers' evaluation or handling of any potential MNPI or for obtaining a representation from the financial advisers concerning their policies and procedures for handling of any MNPI. In connection with this conduct, the adviser was charged with violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Similarly, on August 26, 2024, the SEC announced that it settled charges against a registered investment adviser for its failure to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI concerning its trading of collateralized loan obligations ("**CLOs**").[16] By 2019, the adviser held a large position of term loans of an issuer, and in early 2019, also became a member of a lender group to the issuer. Through its participation in this lender group, the adviser received MNPI about the issuer. In particular, the adviser became aware of the likely failure of an expected major asset sale by the issuer, as well as the issuer's need for immediate financing.

After learning of this MNPI, the adviser sold off two tranches of CLOs that contained loans by the issuer—and the adviser's compliance team approved these transactions. When the MNPI later became public, the prices of the issuer's loans dropped by more than 50% almost immediately, and the CLO tranches which the adviser previously sold declined in value by approximately 11%.

According to the Order, at this time, the adviser maintained an insider trading policy that prevented the adviser from trading in the securities of a company while the adviser was in possession of MNPI about such company, but the policy did not contain any prohibitions on trading a CLO tranche while in possession of MNPI about the underlying loans in the CLO.

As a result of the conduct described above, the SEC charged the adviser with violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. In response to these settlements, advisers should review their policies and procedures regarding misuse of MNPI and ensure that all relevant aspects of their business are appropriately addressed.

CUSTODY RULE ENFORCEMENT ACTIONS

On August 23, 2024, the SEC announced that it settled charges against an investment adviser that was registered with the SEC from November 2019 through March 2023.[17] The adviser stated in its Form ADV that, in lieu of complying with certain requirements of the Custody Rule, the adviser was relying on the exception provided in section (b)(4) of the Custody Rule (the "**Audit Exception**").[18]

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14 The SEC noted in the Order that an adviser's federal fiduciary duty established by the Advisers Act may not be waived, and advisory agreements may not misrepresent, or contain misleading statements regarding, the scope of an adviser's unwaivable fiduciary duty that could lead a client to believe incorrectly that the client has waived a non-waivable cause of action against the adviser. This is true even if there is a disclaimer (i.e., a "savings clause") stating that compliance with state or federal securities law is not waivable.

15 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

16 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

17 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

18 The Audit Exception requires, among other things, that an adviser ensure that a relevant fund undergo an audit at least annually by an independent public accountant registered with the PCAOB, and that such fund's financial statements, prepared in accordance with generally accepted accounting principles, be distributed to all limited partners within 120 days of such fund's fiscal year-end.

According to the Order, while the adviser had engaged a PCAOB-registered accounting firm to conduct financial statement audits for two of the private funds it managed, the firm did not complete the audits until well after 120 days following both such funds' fiscal year-ends. Therefore, the adviser did not distribute the financial statements to limited partners until after the requisite 120-day period as required by the Audit Exception. As a result, the adviser was required to comply with the fulsome provisions of the Custody Rule, including the requirement that client funds and securities be verified by actual surprise examination, which it did not do.

In addition, the adviser failed to promptly file an amendment to its Form ADV to update its response to Part 1A, Schedule D Section 7.B.23.(h) as required by the instructions to Form ADV. In response to such section, the adviser indicated "Report Not Yet Received" with respect to the audit report of one of its private fund clients. The adviser received the audit report for the private fund on April 28, 2022 but did not file an updated Form ADV amendment revising its response to Section 7.B.23.(h) until September 15, 2022. As a result of this conduct and the conduct described above, the adviser was charged with violating Sections 204(a) and 206(4) of the Advisers Act and Rules 204-1(a), 206(4)-2 and 206(4)-7 thereunder.

Similarly, on September 3, 2024, the SEC announced that it settled charges against an investment adviser that was registered with the SEC from July 8, 2022 through December 22, 2022.[19] During this period, a fund advised by the adviser held certain crypto assets in online trading accounts on crypto asset trading platforms, and not with a qualified custodian as required by the Custody Rule.[20] As a result, the SEC charged the adviser with violating the Custody Rule.

In response to these settlements, for every private fund client for which advisers are relying on the Audit Exception, advisers should work closely with their auditors to ensure they are able to disseminate to all limited partners the relevant fund financial statements within the 120-day time period as prescribed by the Audit Exception. Moreover, advisers should ensure that their Form ADV disclosures on this topic are accurate and amended in a timely manner. Finally, advisers should ensure, to the extent they advise any funds holding crypto assets, that such funds are adhering to Custody Rule requirements with respect to such assets, including that such assets be maintained with a qualified custodian.

ENFORCEMENT ACTIONS RELATED TO AFFILIATED SERVICE PROVIDERS

On August 19, 2024, the SEC announced that it settled charges against a registered investment adviser for its (i) custody practices and (ii) failure to implement policies and procedures regarding the use of affiliated service providers.[21] The adviser disclosed in its Form ADV Part 1A that seven of the pooled investment vehicles it advised were subject to an annual audit, and that audited financial statements for the most recently completed fiscal year were distributed to each such vehicle's investors. However, the Order alleges that from October 2019 to November 2022, the adviser failed to obtain audits of the vehicles and distribute the financial statements. As a result, the SEC charged the adviser with violating the Custody Rule.

Also during this time period, two affiliates of the adviser received fees, borne by the adviser's fund clients, in exchange for providing property management and construction services to the real estate assets held by the fund clients. In its offering documents, the adviser disclosed that the fees paid to these affiliates would be at market rates. In its Form ADV Part 2A, the adviser also disclosed that the fees paid to these affiliates were "lower or comparable to those that would be charged in arms' length transactions with third parties," and that it had "adopted written policies and procedures designed to monitor the comparability of its fees with those of unaffiliated third parties."

While the adviser had indeed adopted written policies and procedures to review, no less than annually, the fees charged by the affiliates for their services to ensure they remained at or below market rates for similar services, the SEC found that the adviser did not implement these policies and procedures as written. As a result of this conduct, the adviser was charged with violating Section 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder.

In addition, on September 3, 2024, the SEC announced that it settled charges against a registered investment adviser after various funds advised by the adviser incurred and paid fees and expenses to service providers affiliated with the adviser.[22] The limited partnership agreements ("**LPAs**") of certain of these funds generally required that transactions with affiliates be fully disclosed in advance to such funds' limited partners and approved by such funds' limited partner advisory committees ("**LPACs**") or by a majority-in-interest of limited partners. The Order found that the adviser failed

19 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

20 The Custody Rule requires that registered investment advisers who have custody of client funds or securities comply with several requirements, including that the funds or securities be maintained by a "qualified custodian," defined to include banks, broker-dealers, futures commission merchants registered under the Commodity Exchange Act, and certain foreign financial institutions.

21 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

22 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

to provide the disclosure in advance and to obtain the approvals, each as required by the applicable LPA.

In response to these settlements, advisers should be prepared, where the adviser has disclosed that its use of affiliated service providers is at "market rates," to demonstrate that it has both adopted and implemented policies and procedures to support this disclosure. Advisers should also ensure, where a Fund's LPA requires LPAC or limited partner approval prior to the adviser charging affiliated service provider fees to the Fund, that the adviser is obtaining such approval as required by the LPA.

PAY-TO-PLAY ENFORCEMENT ACTION

On August 19, 2024, the SEC announced that it settled charges against a registered investment adviser for violations of the Pay-to-Play Rule.[23] The Rule prohibits an investment adviser from providing investment advisory services for compensation to a government entity within two years after a contribution to an official[24] of the government entity is made by a covered associate[25] (including a person who becomes a covered associate within two years after the contribution is made).

According to the Order, in December of 2019, an individual made a campaign contribution to an incumbent for elected office in Michigan. The official's office had the ability to influence the hiring of investment advisers for Michigan Public Employees' Retirement Fund, which was an existing investor in a private fund advised by the adviser.

In July of 2020, the individual was hired by the adviser, becoming a "covered associate" under the Pay-to-Play Rule. Between September 2020 and May 2021, the individual solicited government entities on behalf of the adviser by attending and participating in meetings and presentations with government entities which were invested or solicited to invest in funds advised by the adviser. During this time period, which was within the Pay-to-Play Rule's two-year lookback period, Michigan Public Employees' Retirement Fund remained an investor in the private fund advised by the adviser. As a result, the SEC found that the adviser provided investment advisory services for compensation to Michigan Public Employees' Retirement Fund within two years after the covered associate had made a contribution to the Michigan official, in violation of the Pay-to-Play Rule.

The SEC noted that the campaign contribution triggered a "time out" on the adviser receiving compensation for the advisory services it provided to Michigan Public Employees' Retirement Fund, which such "time out" period began once the individual became a covered associate of the adviser, and continued until two years had elapsed from the date of such individual's political contribution. In response to this settlement, advisers should carefully monitor political contributions by both existing employees and new hires to ensure that the adviser is not running afoul of the Pay-to-Play Rule's prohibitions.

ENFORCEMENT ACTIONS RELATED TO OFF-CHANNEL COMMUNICATIONS

On September 24 and August 14, 2024, the SEC announced that it settled charges against 11 firms and 26 firms, respectively, including several registered investment advisers, for widespread failures by the firms and their personnel to maintain and preserve electronic communications.[26] In connection with the charges, the SEC uncovered "pervasive and longstanding use" of off-channel communications by personnel of the various firms, including personnel at various levels of authority, including supervisors and senior managers.

As a result, the Orders alleged that the firms were unable to meet their recordkeeping obligations, and all were charged with violations of the recordkeeping provisions of the Exchange Act, the Advisers Act, or both, as well as with failing to reasonably supervise their personnel to prevent and detect such recordkeeping violations.

Relatedly, on September 23, 2024, the SEC announced that it settled charges against a registered investment adviser concerning its failure to maintain and preserve off-channel communications.[27] According to the Order, from at least May 2019 through October 2021, adviser personnel, including senior personnel, sent and received off-channel communications related to recommendations and advice given or proposed to be given in connection with the adviser's advisory business, as well as communications related to placing and executing orders for the purchase and sale of securities for advisory clients.

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23 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

24 The Pay-to-Play Rule defines an "official" as any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office (i) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) has authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity.

25 The Pay-to-Play Rule defines a "covered associate" of an investment adviser as (i) any general partner, managing member or executive officer, or other individual with a similar status or function; (ii) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee; and (iii) any political action committee controlled by the investment adviser or by any person described in (i) and (ii).

26 Press releases related to the settlements, along with links to the full SEC Orders, can be found here and here, respectively.

27 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

The adviser, which identified these communications in the course of responding to an SEC subpoena related to another entity, failed to retain a portion of these communications as required by the Advisers Act. As a result, the adviser was charged with violating Rule 204-2(a)(7) under the Advisers Act. Notably, however, the SEC did not impose a penalty because the adviser self-reported the conduct, took prompt steps to remediate the violations and cooperated with the SEC in its investigation of the other entity.

These settlements highlight the SEC's continued focus on off-channel communications and the policies and procedures designed to prevent such communication. In response to these settlements, advisers should ensure that their books and records policies prohibit the use of personal communication channels—including text messaging on personal devices and messaging on social media platforms—in order to ensure that applicable electronic communications are being appropriately preserved.

ENFORCEMENT ACTIONS RELATED TO DISCLOSURE OF CONFLICTS OF INTEREST

On September 26, 2024, the SEC announced that it settled charges against a formerly registered investment adviser for failing to disclose payments which the adviser received from third-party investment advisers and the resulting conflicts of interest.[28] From September 2020 through May 2024, the adviser had in place agreements with unaffiliated investment advisers pursuant to which these advisers invested their clients' assets alongside the adviser's private funds in an activist investment strategy. The agreements also provided that a performance-based fee, equal to a fixed percentage of any profits earned by these advisers in relation to the joint investment arrangement, would be paid to the adviser.

According to the Order, this arrangement created a conflict of interest because it created an incentive for the adviser to favor the interests of the outside investment advisers over those of its clients. The adviser failed to disclose these payments and the conflicts, and the adviser's policies and procedures failed to ensure this arrangement was appropriately documented. As a result of this conduct, the adviser was charged with violating Sections 206(2) and 206(4) of the Advisers Act, as well as Rule 206(4)-7 thereunder.

Similarly, on September 20, 2024, the SEC announced that it settled charges against a registered investment adviser for failing to properly disclose and gain consent for certain loan transactions involving conflicts of interest.[29] According to the Order, the adviser caused an entity wholly owned by one of its private fund clients to obtain a short-term loan from a lender. The adviser's executive director and chief compliance officer, the individual who negotiated the loan on behalf of the private fund client, also sat on the board of directors of the lender's 50% owner. In addition, the adviser and a related entity made two loans to the adviser's private fund clients. According to the Order, the adviser failed to disclose the existence of these conflicts to, and failed to obtain the required consents from, the relevant private fund clients. As a result, the adviser was charged with violating Section 206(4) of the Advisers Act.

Lastly, on August 12, 2024, the SEC announced that it had settled charges against a dually-registered investment adviser and broker-dealer in connection with its receipt of third-party compensation based on advisory client investments without full and fair disclosure of the associated conflicts of interest.[30]

Beginning in January 2017, the adviser had an arrangement with an unaffiliated clearing broker through which the adviser shared in a portion of the recurring fee paid by the adviser's mutual funds to the clearing broker. As such, investors in the adviser's mutual funds indirectly paid this fee when it was included in the mutual funds' expense ratio. For certain mutual fund share classes, the clearing broker charged no transaction fees for the purchase and sale of such shares, but charged a higher recurring fee with respect to such shares. As a result, because the adviser shared in the recurring fee, it was incentivized to recommend to clients the mutual fund share classes that generated the higher recurring fee, even though lower-cost classes of the same mutual funds were also generally available for which the adviser would have received little or no revenue sharing.

The adviser and clearing broker also had an arrangement through which the adviser shared in the clearing broker's revenue received in connection with certain money market funds offered to the clearing broker's sweep accounts. The amount of revenue sharing the adviser received depended on the money market account recommended by the adviser and selected by its advisory clients. From at least January 2017 until January 2023, the adviser made available to its advisory clients only money market fund options for which it received revenue sharing payments from the clearing broker, even though the clearing broker made other money market funds available to the adviser for which the adviser would have received little or no revenue sharing.

28 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

29 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

30 A press release related to the settlement can be found here. A link to the full SEC Order can be found here.

Finally, the arrangement between the adviser and clearing broker also provided that the adviser would charge a transaction fee markup to its brokerage customers, resulting in the adviser's brokerage customers paying a higher transaction fee than the adviser paid to the clearing broker.

In each case, the adviser failed to disclose the conflict of interest inherent in (i) its recommendation of mutual fund share classes and money market funds that paid revenue sharing to the adviser and (ii) the transaction fee markup. The Order noted that the adviser breached its duty to seek best execution, part of an adviser's duty of care, by causing certain advisory clients to invest in share classes of mutual funds that resulted in higher revenue sharing payments from the clearing broker when share classes of the same funds were available that presented a more favorable value under the particular circumstances. The Order also held that the adviser breached its duty of care by failing to undertake an analysis to determine whether the particular mutual fund share classes or money market funds it recommended were in the best interests of its advisory clients.

The SEC attributed the above conduct to the adviser's failure to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder concerning disclosure of all material facts, including practices around selection of mutual fund share classes and money market funds, transaction fee markups, and resulting conflicts of interest. As a result, the adviser was charged with violating Section 206(2) and Section 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder.

These settlements underscore the SEC's continuing focus on full and fair disclosure of conflicts of interest, and an adviser's written policies and procedures to ensure all material conflicts are properly disclosed. In response to these settlements, advisers should review their existing conflicts disclosure, and the corresponding policies and procedures governing such disclosure, and make any necessary revisions in order to ensure full and fair disclosure of all relevant conflicts of interest attendant to an adviser's business.

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