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Trio of Enforcement Cases against Fund Advisers Signals Status Quo from SEC

By Nicolas Morgan, Thomas A. Zaccaro, Arthur L. Zwickel, Yousuf I. Dhamee, Tram N. Nguyen & Kyle M. Jones

If recent SEC Enforcement cases are any indication, the Commission's agenda in the private fund adviser space appears largely unchanged for 2017 despite a new administration and a new acting SEC Chair. Conflicts of interest, valuation, and SEC filings' accuracy continue to top the agenda.

Valuation of Fund Assets

On March 29, the SEC announced an action against an Oklahoma-based private fund adviser for overvaluing municipal bonds held by its funds. By the time the SEC brought this action, the fund adviser had already refunded management fees directly to the funds and paid additional money to the funds to compensate them for overpayment of redemptions. In light of those remedial efforts, the SEC censured the adviser and imposed a $130,000 civil penalty.

The adviser used a third-party pricing service to value the municipal bonds despite the fact that the pricing service's values diverged from "fair value" under Generally Accepted Accounting Principles ("GAAP") after a period of significant market volatility. The SEC found fault with the continued use of the pricing service's valuation because the funds previously sold some of the municipal bonds at prices materially lower than this valuation.

The SEC contended that this advisor's valuations were inconsistent with representations made in the funds' financial statements, written valuation policy, private placement memoranda ("PPMs"), and limited partnership agreements. Specifically, the valuation policy stated that the adviser "evaluates the compilation of pricing data it acquires and considers factors specific to each position." According to the SEC, the adviser failed to adequately evaluate or consider these factors.

Troublingly, the SEC implied that the adviser valued assets in "bad faith" simply because the valuations were neither GAAP compliant nor consistent with the funds' stated valuation methodology. To conclude, without more, that this valuation was in "bad faith," represents an aggressive inference by the SEC. Advisers should be aware that a failure to take all measures specifically enumerated in a valuation policy may result in accusations of "bad faith."

The SEC's eagerness to conclude "bad faith" fails to appreciate the complexity and ambiguity of valuing illiquid or infrequently-traded assets. The SEC seems to believe that the market price always reflects the fair value of an asset. While that is often an effective method for determining fair value for securities actively traded on an exchange or other public market, where the volume of transactions makes determining fair value straightforward, it is less viable for valuing securities that are not actively traded. Instead, illiquid or infrequently traded assets more often require other observable market inputs, such as prices for similar actively traded securities, to determine their value. Even these comparable sales are sometimes unavailable, however, causing fair value to be determined through a subjective and judgment-laden analysis of the perspectives of silent market participants.

This case follows the form of prior SEC cases in the fund adviser space in which two valuation issues stand out as receiving particular attention:

- The stated valuation policies differ from actual valuation practices; and
- The valuations fail to adequately incorporate knowledge of actual market transactions.

Failure to Report Beneficial Ownership of Securities

On February 14, the SEC announced an action against several activist funds, advisors, and others for failing to file adequate or timely schedules disclosing beneficial ownership of securities in certain portfolio companies. The SEC ordered the funds and their advisers to cease and desist from future violations and imposed penalties ranging from $30,000 to $180,000 for the individuals and entities involved.

Section 13(d) of the Securities Exchange Act and related rules require any person or group who directly or indirectly acquires beneficial ownership of more than five percent of certain equity securities to file a Schedule 13D within 10 days of acquiring beneficial ownership. A Schedule 13D discloses information relating to such beneficial ownership. If a material change occurs to the facts set forth in any disclosure statement filed on a Schedule 13D, it must be promptly amended.

According to the SEC, the funds' Schedules 13D were inadequate because they:

- Failed to disclose an intent to influence control of the issuer;
- Failed to adequately disclose the group's intent to sell off the company's existing line of business and convert the company into an acquisition shell;
- Intentionally delayed the disclosure of the group's beneficial ownership by several weeks to enable the group to buy more stock and reduce the time the issuer could engage in defensive measures;
- Failed to disclose the coordination between funds that resulted in the issuer's 13.75% total beneficial ownership; and
- Failed to include in a beneficial ownership group an investor who shared in research and coordinated efforts to change the make-up of the issuer's board of directors.

This case signals the SEC's continued willingness to bring actions to enforce even minor violations of beneficial ownership reporting requirements. These violations did not involve a complete failure to disclose. Rather, these violations involved incomplete or untimely disclosures. Determining who is a "beneficial owner," who "indirectly" owns securities, and what constitutes a "group" acting with common purpose are all issues confronted by activist funds and their managers. Much to their chagrin, the SEC shows little sign of easing up on its scrutiny of such judgment calls and reporting obligations.

Failure to Disclose Fees and Conflicts of Interest

Since the beginning of 2017, the SEC has announced two cases involving the types of violations it has long pursued against private fund advisors. In each case, the SEC alleged that the investment advisers failed to disclose to advisory clients compensation received from third parties. In the SEC's view, the receipt of these fees created an undisclosed conflict of interest and breached fiduciary duties.

Although not specifically brought against private fund advisers, these actions are consistent with prior SEC cases against private equity and hedge fund advisors. The SEC has a long history of bringing enforcement actions alleging securities law violations, breaches of fiduciary duty, or conflicts of interest resulting from practices that diverged from representations found in Form ADVs, limited partnership agreements, subscription agreements, and other documents concerning fee and revenue related topics such as:

- The allocation of fees received from portfolio companies;
- The allocation of broken deal expenses to funds; and
- The allocation of adviser regulatory expenses to funds.

Conclusion

While more changes at the SEC lie ahead, predicting any dramatic course correction in Enforcement matters against private fund advisors appears premature. The first handful of cases issued by the "new" SEC involving fund advisors and other similarly situated parties suggests an interest in pursuing the same types of cases issued by the "old" SEC: cases alleging improper valuation, undisclosed conflicts of interest, and failure to adequately report beneficial ownership of securities.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Yousuf I. Dhamee
1.213.683.6179
yousufdhamee@paulhastings.com

Thomas A. Zaccaro
1.213.683.6185
thomaszaccaro@paulhastings.com

Nick Morgan
1.213.683.6181
nicolasmorgan@paulhastings.com

Arthur L. Zwickel
1.213.683.6161
artzwickel@paulhastings.com

New York

Tram N. Nguyen
1.212.318.6848
tramnguyen@paulhastings.com