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SEC Enforcers Continue to Focus on Undisclosed Fees

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In a series of enforcement cases over the past few months, the SEC has continued to bring actions focused on undisclosed fees charged to clients. Many of these cases have charged firms with fraud and other violations based on fees that were not adequately disclosed. While some attention has focused on retail wealth managers, institutional advisers to private funds have attracted scrutiny for undisclosed fees, leading to the following enforcement actions:

- In August of 2019, the SEC charged a private venture capital fund adviser, Frost Management Company, LLC, with fraud and breach of fiduciary duties based on over $14 million in undisclosed incubator fees to start-up companies in which their fund clients invested. The complaint alleges that Frost offered incubation services to the start-ups in which it invested, and that these incubation services were provided through an affiliated entity. However, the SEC alleged that the fees paid to the affiliate, which were supposed to be used for "operational support," were in fact used to fund the principal's personal expenses. Furthermore, the SEC alleged that, contrary to representations to investors, the fees that its portfolio companies were paying to the affiliate were not below market rate. The case is currently ongoing, and the SEC is seeking injunctions, disgorgement and prejudgment interest, and civil penalties.
- Also in August of 2019, the SEC settled charges against MVP Manager LLC based on allegations regarding undisclosed brokerage commissions for acquisitions of pre-IPO shares. MVP's clients were private funds that invested in the securities of pre-IPO venture-backed companies. The order alleged that MVP personnel arranged to receive an undisclosed brokerage commission on the sale of pre-IPO securities to MVP's client funds on three separate occasions. The order further alleged that this undisclosed commission created a conflict of interest, as MVP and its personnel had an economic incentive to cause the private funds to purchase the securities. MVP agreed to violations of the antifraud provisions of the Advisers Act, and repaid $170,000 worth of undisclosed fees along with an $80,000 penalty.
- Earlier in July of 2019, the SEC settled another conflicts of interest case against the principal of Genesis Capital LLC based on undisclosed fees. The order alleged that Genesis failed to disclose certain conflicts of interest that resulted from

investments in, and fees paid to, companies that were affiliates of the adviser. The settlement involved violations of the antifraud provisions of the Adviser's Act, disgorgement, and a $75,000 civil penalty.

- In September 2019, the SEC brought an action against a fund-of-funds manager for an undisclosed fee sharing agreement. The order alleged that the manager's principal had arranged a separate fee-sharing arrangement with the manager of one of the underlying fund investments, but did not disclose the agreement to the fund-of-funds investors. This undisclosed fee arrangement resulted in an conflict of interest as to fund investors, and a settlement involving the antifraud provisions of the Advisers Act.

Retail wealth managers have also faced scrutiny, often in connection with more complex alternative investments. For instance:

- An undisclosed 7% commission charge for alternative investments where an alternative share class (without embedded commissions) was available;
- An undisclosed 5% commission that an adviser received when his clients invested in certain promissory notes;
- Approximately $254,000 in undisclosed fees that were generated in exchange for recommending investments in certain private real estate funds; and
- A revenue sharing agreement leading to undisclosed conflicts in recommending mutual fund share class investments that resulted in over $100 million being paid to the adviser.

From the SEC's perspective, fund advisers are fiduciaries to their clients including the funds they advise and, in the context of that relationship, any ambiguities in fee disclosure are likely to be examined closely and create risk. Given the SEC's continuing focus in the area, all advisors should focus on all fees, in whatever form, from all sources and ensure that they are adequately disclosed to investors and clients.

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