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Mid-Year Enforcement Update: SEC's Continued Focus on Private Funds in 2024

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As we reach the midpoint of 2024, the SEC has maintained its rigorous enforcement stance on the private funds industry, proposing new rules and oversight tools to better identify and investigate market practices. As 2024 continues, we expect to see more scrutiny of private fund managers in the SEC's longstanding focus areas — for example, its focus on the fiduciary obligations of private fund managers. Notwithstanding the recent setbacks in its rulemaking efforts, the SEC concerns regarding private fund advisers underlying the rulemaking will continue.

1. **Private Fund Adviser Rules**

The Fifth Circuit recently invalidated the entirety of the SEC's Private Fund Adviser Rules, holding that the SEC exceeded its statutory rulemaking authority. This successful industry challenge may cut both ways. In part, the Fifth Circuit based its ruling on the lack of a "rational connection" between the broad disclosure and other requirements adopted in the Private Fund Adviser Rules and the prevention of fraud. In part, the court stated that the SEC had not sufficiently defined or identified fraudulent acts or practices by private fund advisers (which would fall under the antifraud rulemaking authority found in Section 206(4) of the Advisers Act). As a result, the SEC staff may redouble its efforts to identify private fund cases, motivated to highlight problematic conduct that falls within the general categories in the now-invalidated rules. These variables may drive further regulatory scrutiny.

2. **Off-Channel Recordkeeping**

After a number of cases against dual registered broker-dealers/investment advisers, the SEC announced its first settlement with a stand-alone registered investment adviser in its ongoing off-channel messaging sweep. This is the latest in a string of well-publicized settlements imposing penalties on financial firms for recordkeeping violations relating to "off-channel" text messaging.

In April 2024, the SEC reached a settlement with hedge fund adviser Senvest Management LLC regarding failure to maintain and preserve electronic communications and to enforce its code of ethics. The SEC noted that firm employees used personal messaging applications for company business, violating firm policies. This included senior employees using personal devices, some of which were set to delete messages automatically after 30 days. The settlement involved other compliance issues, noting that some employees did not obtain pre-clearance for personal securities transactions. As in other off-channel settlements, the firm admitted the violations and was required to retain an independent compliance consultant.

While private fund advisers are becoming accustomed to the SEC's scrutiny of off-channel communications, the prevalence of text messaging poses challenges. Smaller asset managers may face similar scrutiny as the SEC intensifies its focus. Firms are advised to reassess their policies and compliance with recordkeeping requirements related to off-channel communications. Key considerations include updating policies and procedures, enhancing detection and surveillance mechanisms, managing devices and platforms and establishing protocols for handling violations.

3. **Artificial Intelligence (AI-washing)**

The SEC has been warning firms for the past year not to make unsubstantiated claims about use of artificial intelligence (AI); calling out this topic is a heightened focus area for the Commission. In two recent SEC enforcement actions announced in April 2024, two investment advisers faced charges for making false statements regarding their use of AI to retail investors.

These cases were not focused on potential conflicts or the appropriateness of various AI use cases, but instead alleged that the advisers made misleading claims to prospective clients regarding their AI capabilities. However, the SEC's recent actions underscore the importance of transparency and accuracy when making AI and other technological claims. In the exam and enforcement context, any use of AI by fund managers will draw heightened interest, whether marketed to clients or simply used internally.

4. **Pay-to-Play Rule**

With the federal election coming up, advisers should be on high alert for political contributions implicating the pay-to-play rule. Also in April 2024, the SEC announced a settlement with a private equity adviser alleging violations of the SEC's pay-to-play rule for investment advisers, as we discussed in this post.

We have added this order and other orders discussed in this update to our database tracking SEC enforcement actions involving private equity advisers, available here.

Key Takeaways:

- ***Follow your written policies***, including the maintenance of any preclearance logs and proper documentation.
- ***Train your personnel*** to ensure all covered associates understand the rule, its application to their donations and the firm's policies and preclearance requirements.
- ***Be vigilant*** and provide personnel with questionnaires and pre-approval reminders. Investigate any prior political donations by new hires.
- ***Act quickly*** if a potential issue arises, and take immediate steps to mitigate. Early detection can allow for corrections, such as using the exception for "returned" contributions if the amount does not exceed $350, and is discovered within four months and then returned within 60 days after discovery. (Rule 206(4)-5(b)(3))

5. **MNPI and Shadow Trading**

The SEC obtained a jury verdict in the so-called "shadow trading" case that recently went to trial, regarding stock trades in a company with which the individual had no connection and no pre-existing duty of confidentiality. In April 2024, a federal jury found Matthew Panuwat liable for insider trading after the SEC sued him for using confidential information about a pending acquisition of his own employer to buy call options in another similar company.

The SEC's senior officials have repeatedly stated that this was a case simply about misuse of confidential information in breach of the duty Panuwat owed to his employer, using well-established historical theories of insider trading. However, the industry has reason to be somewhat concerned about the apparent expansion of insider trading law to cover trading in related companies in a sector, not limited to a particular company that may be restricted as a result of receiving potential MNPI.

Key Takeaways:

The focus on MNPI policies and procedures remains a priority for the SEC, as illustrated by the settlement announced at the end of 2023 charging a private equity fund manager with MNPI policy violations for disclosures by senior personnel of merger-related MNPI to investors and industry contacts. Fund managers should therefore consider additional MNPI training for employees on the Panuwat fact pattern and be on heightened awareness for factual situations that might be subject to the same analysis. Also, when signing Non-Disclosure Agreements as to a particular issuer or transaction, consider whether the language can be negotiated in a way that does not overly restrict the firm's trading activities.

6. **Trading Violations**

a. Section 13 Filings – Moving from Passive to Active Status

The SEC's March 2024 enforcement settlement with HG Vora Capital Management underscores the importance of correctly filing these disclosures. As we noted in this post, the SEC alleged that HG Vora failed to switch from a Schedule 13G to a Schedule 13D within 10 days of no longer being a passive investor, as required. The SEC noted that the firm became active when it "first considered making its own acquisition bid" with financial backing, "began drafting an offer letter" for the company's outstanding common stock and included a "'placeholder' offer price of $85 per share." The firm's 5% interest in a public company and subsequent actions aimed at influencing the company triggered this requirement, demonstrating the SEC's broad interpretation of what constitutes a "control purpose."

b. Rule 105 of Reg M

In February 2024, the SEC settled charges with an investment adviser for violating Rule 105 of Regulation M, which prohibits short selling an equity security during a restricted period before a public offering and then purchasing the same security in the offering. The violations occurred in April and June 2020, and the adviser has since revised its policies to comply with SEC regulations. The SEC announced a similar settlement with a Canadian investment adviser in October 2023.

7. **Fraud Cases Involving Investment Advisers**

The SEC brought fraud charges in April and May 2024 against two investment advisers, one of which was settled, while the other is being litigated:

- The founder of The Cheetah Fund L.P., an Atlanta-based hedge fund, was sued for defrauding investors. Allen allegedly deceived investors by misrepresenting the fund's performance, despite incurring substantial trading losses exceeding $4.59 million. The SEC asserts that Allen falsely claimed that the fund was audited by an accounting firm and that despite little or no legitimate fund profits, he received over $2.64 million in compensation. Allen has only returned about $900,000 to investors, resulting in approximately $9 million in losses. The complaint charges Allen with violations of the antifraud provisions. This is a litigated action, with parallel criminal charges filed against Allen in the Northern District of Georgia.
- Hedge fund adviser, Mass Ave Global Inc., along with its co-founder and CEO, was charged with making false and misleading statements to investors and failing to disclose conflicts of interest. From 2020 to 2022, the fund manager allegedly provided inaccurate information about its flagship opportunity fund's holdings and exposures. Specifically, the adviser manipulated portfolio data included in investor communications (i.e., inaccurately amending its lists of top 10 holdings driving performance), failed to disclose a conflict of interest involving its other co-founder running a separate hedge fund in China, and had inadequate compliance policies and procedures. As a result of these actions, MassAve agreed to pay a $350,000 civil penalty, while its former CEO faces a $250,000 penalty and a 12-month industry suspension. Following an internal review and disclosure of these revelations, the firm began winding down operations after receiving numerous redemption requests.

8. **Hypothetical Performance - Marketing Rule Violations**

In April 2024, the SEC announced settled charges against five registered retail-focused investment advisers for violating the new Marketing Rule. These firms broadly advertised hypothetical performance on their websites without adequate policies and procedures relating to hypothetical performance data. Specifically, the firms allegedly failed to: (a) develop and implement policies and procedures reasonably designed to ensure that hypothetical performance was relevant to the likely financial situation and investment objectives of the intended audience; (b) ensure that the advertised hypothetical performance was not misleading or misrepresentative; and (c) substantiate the performance figures presented in their advertisements. Although the penalty amounts were not large, some of the firms received reduced penalties due to corrective steps taken before being contacted by the SEC. The SEC's actions underscore the focus on the updated Marketing Rule and efforts to maintain the integrity of firms' advertising practices.

9. **Indemnification/Exculpation Provisions**

Looking forward, there may be increased attention on indemnification or exculpation provisions. As we previously noted, the SEC's final Private Fund Adviser Rules did not include a ban on contractual indemnification or exculpation provisions as originally proposed, yet the SEC clarified that, in its view, existing antifraud provisions under the Advisers Act already forbid contractual "waivers" of an adviser's federal fiduciary duty. The SEC stressed that seeking reimbursement, indemnification or exculpation for breaching federal fiduciary duty would essentially act as a waiver, making those invalid under the Act.

However, the SEC made a distinction between institutional and retail clients, and recent enforcement actions involving improper "hedge clauses" given to retail clients highlight the SEC's commitment to protecting retail investors in particular. This insight from the SEC directly affects private fund advisers, requiring them to review and potentially revise existing contractual indemnification and exculpation arrangements, especially for 3(c)(1) funds with retail investors.

Key Takeaways:

- ***Review and update*** indemnification and exculpation clauses to ensure compliance with SEC regulations.
- Provide ***complete and clear disclosure***, particularly to retail clients, to avoid enforcement actions.
- ***Identify potential gaps*** in indemnification coverage and discuss them with insurers.

10. **Cooperation**

In a May 23, 2024, speech, the SEC's Enforcement Director Gurbir Grewal outlined five principles of effective cooperation in SEC investigations. Although many in the defense bar can debate how much credit the SEC staff gives to self-reporting and cooperation, below are the principles he summarized:

- Principle One - Self-Policing: Before problems arise, foster a strong culture of compliance, stay updated on regulatory developments and maintain robust policies and procedures.

- Principle Two - Self-Reporting: Promptly self-report to the SEC, even at an early stage of an inquiry. This signals a proactive compliance culture and helps build credibility.
- Principle Three - Remediation: Take timely and meaningful steps to remediate the identified issues, including disciplining those responsible, improving internal controls, and compensating harmed investors.
- Principle Four - Cooperation: Go above and beyond legal obligations. For example, assist the SEC by providing relevant information, explaining critical documents, facilitating witness access and sharing findings from internal investigations.
- Principle Five - Collaboration: Maintain regular and transparent communication with the SEC staff to streamline investigations and resolve issues efficiently.

Looking Ahead: Second Half of 2024

As we reach the midpoint of 2024, we believe that the regulatory focus will remain on fiduciary obligations. Fund managers should stay prepared and compliant with the following considerations in mind:

- ***Continued Enforcement:*** Private fund managers should prepare for rigorous enforcement of SEC rules, particularly regarding fiduciary duties, marketing practices and recordkeeping integrity. The recent invalidation of the SEC's Private Fund Rules may lead to greater effort by the exam and enforcement staff to use its existing investigative authority to highlight perceived problematic practices in the industry.
- ***Election Impacts:*** With the upcoming presidential election adding a layer of uncertainty, regulatory priorities could shift, necessitating adaptability.
- ***Proactive Compliance:*** Maintaining transparency, robust internal controls and proactive compliance measures will be essential to navigate the evolving regulatory landscape. The SEC's active enforcement stance underscores the importance of adhering to regulatory standards in the months ahead.

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