Private Funds
Alert

Weil

February 14, 2024

Recent Regulatory Developments Applicable to Private Fund Sponsors

By David Wohl, Christopher Scully, John Bradshaw and Stephen Filocoma

Over the course of the last year, there have been a number of regulatory developments affecting private funds and their investment advisers that private equity sponsors should be aware of. To assist our clients with tracking the changing regulatory landscape of the private equity industry, this memo summarizes notable legal developments and related Securities and Exchange Commission ("SEC") Enforcement Actions affecting private equity sponsors and their affiliates in the past year.

I. ADOPTED RULES

FinCEN's Final Rule Regarding the Corporate Transparency Act's Beneficial Ownership Reporting Requirements Becomes Effective

On January 1, 2024, the Financial Crimes Enforcement Network's ("**FinCEN**") final rule implementing the beneficial ownership information ("**BOI**") reporting requirements under the Corporate Transparency Act ("**CTA**") became effective.[1]

The final rule requires certain US domestic and foreign companies ("**Reporting Companies**") to submit BOI reports to FinCEN with respect to any natural persons who directly or indirectly own or control at least 25% of, or otherwise exercise "substantial control" over, a Reporting Company ("**Beneficial Owners**").

While the categories of entities considered Reporting Companies are broad, the final rule includes a number of exemptions applicable to the private fund industry. Among the exempted entity types are (i) registered investment advisers ("**RIAs**") and their relying advisers; (ii) Venture Capital Advisers filing with the SEC as exempt reporting advisers ("**VC ERAs**"); (iii) certain "Pooled Investment Vehicles" ("**PIVs**")[2]; (iv) non-US entities (including private funds and advisers) that are not registered to do business in the US; (v) large operating companies that satisfy certain conditions and (vi) controlled or wholly owned subsidiaries of certain exempted entities.

[1] The CTA 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] The CTA's definition of "Pooled Investment Vehicle" includes any entity that (i) qualifies as an investment company under Section 3(a) of the Investment Company Act or (ii) relies on a Section 3(c)(1) or 3(c)(7) exemption under the Investment Company Act and is (or will be) identified on an RIA's Form ADV (*e.g.*, a private fund).

While many private funds and advisers are covered under one of the above exemptions, advisers should note that certain other entities are (or in certain cases, are likely to be) required to submit BOI reports, including (i) advisers that are not RIAs or VC ERAs (*e.g.*, other types of ERAs) and any funds managed by such advisers; (ii) other types of PIVs (*e.g.*, real estate vehicles relying on the Section 3(c)(5)(C) exemption under the Investment Company Act of 1940, as amended (the "**Investment Company Act**")); (iii) non-US entities registered to do business in the US[3] and (iv) subsidiaries of an exempt PIV (unless another exemption applies).

Under the final rule, Reporting Companies (i) existing prior to January 1, 2024 have until January 1, 2025 to file an initial report; (ii) 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 and (iii) 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.

New York Adopts Limited Liability Company Beneficial Ownership Information Reporting Law

On December 22, 2023, New York Governor Kathy Hochul signed the New York LLC Transparency Act (the "**LLCTA**") into law.[4] Modeled after FinCEN's CTA, once effective, the LLCTA will require all limited liability companies that are either formed under New York law or registered to do business in New York ("**NY LLCs**") to report certain BOI to the New York Department of State ("**NYDOS**"), unless an exemption applies.

The LLCTA contains reporting exemptions that are modeled on the CTA's 23 reporting exemptions. However, unlike the CTA, the LLCTA's reporting requirements are limited to NY LLCs (as opposed to the CTA, which, in addition to limited liability companies, requires partnerships, corporations and other entities to report BOI). In addition, the LLCTA requires NY LLCs relying on a BOI reporting exemption to affirmatively assert such exemption to the NYDOS by submitting a statement specifying the exemption on which the exempt NY LLC intends to rely.

The effective date of the LLCTA is December 21, 2024. Non-exempt NY LLCs formed or registered prior to this date must file BOI reports with the NYDOS by January 1, 2025. Any non-exempt NY LLC formed after the effective date will be required to submit BOI reports upon the filing of its articles of formation.

Private Fund Adviser Rules

On August 23, 2023, the SEC adopted new rules and amendments under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), that significantly increase the regulation of private fund advisers.[5] The final rules establish a more prescriptive, rules-based regulatory regime for private fund advisers designed to protect investors through increased transparency, competition and efficiency in the private fund market.

---

[3] Foreign PIVs registered to do business in the US need only identify "an individual that exercises substantial control over the pooled investment vehicle," as opposed to all of the PIV's Beneficial Owners.

[4] The full text of the LLCTA can be found here.

[5] The final rules' adopting release can be found here. A related fact sheet and press release can be found here and here, respectively. A previous alert discussing the final rules can be found here.

Restricted Activities

The final rules impose disclosure, notice and, in some cases, consent requirements (but generally do not ban) certain activities that could involve conflicts of interest between an adviser and its private fund[6] clients (and investors). Specifically, the final rules restrict the ability of all private fund advisers, including those that are not registered with the SEC (such as exempt reporting advisers and state-registered advisers), to (i) charge a fund or investors for fees or expenses associated with a regulatory investigation of the adviser or its related persons; (ii) charge a fund or investors regulatory, examination or compliance fees or expenses of the adviser or its related persons; (iii) reduce the amount of any adviser clawback[7] by taxes applicable to the adviser, its related persons or their respective owners or interest holders; (iv) charge a fund or investors for fees or expenses related to a portfolio investment on a non-pro rata basis where multiple managed funds invest in such portfolio investment and (v) borrow from a fund client.

Preferential Treatment

The final rules prohibit all private fund advisers, including those not registered with the SEC, from providing preferential treatment to certain investors regarding:

- Certain redemptions from the fund and certain preferential information about portfolio holdings or exposures, unless such items are offered to all other investors or, in the case of redemptions, required by applicable law;
- Material economic terms, unless the adviser provides advance written notice of the specifics of such preferential treatment to all prospective investors;
- Any other preferential treatment, unless the adviser provides written disclosure to investors of all preferential treatment as soon as reasonably practicable following the end of the fund's fundraising period (for an illiquid fund) or following an investor's investment (for a liquid fund).

Further, on at least an annual basis, an adviser must provide a written notice to investors that provides specific information regarding any preferential treatment provided to other investors since the last written notice provided in accordance with the rules.

Quarterly Reporting Requirements

The final rules impose standardized quarterly reporting requirements on private fund advisers registered with the SEC (but not, *e.g.*, exempt reporting advisers or state-registered advisers) requiring disclosure to investors of fund performance, investment costs, fees and expenses and manager compensation.

Adviser-Led Secondary Transactions

The final rules require registered private fund advisers to (i) obtain either a fairness opinion or a valuation opinion from an independent opinion provider in connection with any adviser-led secondary transaction and (ii) prepare and distribute to investors a written summary of any material business relationships the adviser has, or has had within the prior two years, with the independent opinion provider.

---

[6] A "private fund" is an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of that Act. However, the final rules generally exclude securitized asset funds from this definition.

[7] An "adviser clawback" is defined as any obligation of the adviser, its related persons or their respective owners or interest holders to restore or otherwise return performance-based compensation to the private fund pursuant to the private fund's governing agreements.

Private Fund Audits

The final rules require a registered adviser to obtain an annual financial statement audit of each private fund it advises. Such audits must satisfy the requirements of the audit provision in Rule 206(4)-2 under the Advisers Act (the "**Custody Rule**").

Compliance and Books and Records Rules

The SEC amended the Advisers Act's (i) compliance rule (Rule 206(4)-7) to require all RIAs to document *in writing* the annual review of their compliance policies and procedures and (ii) books and records rule (Rule 204-2) to require RIAs to retain books and records to facilitate compliance with the final rules.

Compliance Dates and Legacy Status

The final rules' requirements regarding quarterly statements and private fund audits have a compliance date of March 14, 2025. Compliance with the amended Advisers Act compliance rule has been required since November 13, 2023. For the remaining requirements, the compliance dates are: for advisers with $1.5 billion or more in private fund assets under management, September 14, 2025, and for advisers with less than $1.5 billion in private fund assets under management, March 14, 2025.

The final rules provide "legacy status" (*i.e.*, grandfathering) for the prohibitions aspects of the preferential treatment rule (*i.e.*, redemptions and portfolio information) and the aspects of the restricted activities rule that require investor consent (*i.e.*, restricting an adviser from borrowing from a private fund and from charging for certain investigation fees and expenses). However, the SEC's adopting release clarifies that legacy status will only apply to agreements entered into in writing prior to the compliance date with respect to private funds that have commenced operations as of the compliance date.

Advisers Act Marketing Rule and SEC Risk Alert

On June 8, 2023, the SEC's Division of Examinations (the "**Division**") issued a risk alert[8] outlining its broadened areas of focus for examinations of RIAs under Rule 206(4)-1 of the Advisers Act (the "**Marketing Rule**").

Specifically, the alert noted that the Division is conducting focused examinations, as well as broad reviews, for Marketing Rule compliance applicable to advisers' use of testimonials, endorsements and third-party ratings in advertisements, including whether (i) advisers' advertisements contain certain disclosures required under the Marketing Rule regarding persons providing endorsements or testimonials or any third-party ratings and (ii) advisers have met all of the Marketing Rule's oversight and compliance conditions. Additionally, the risk alert noted that examinations will review whether advisers have accurately completed their Forms ADV to provide required information regarding marketing practices. In response, advisers should carefully reflect upon their marketing practices, policies and procedures and implement any necessary modifications to their training, supervisory, oversight and compliance programs to ensure Marketing Rule compliance.[9]

[8] The risk alert can be found here.

[9] A link to the SEC's FAQ addressing certain interpretive issues can be found here. A previous alert discussing the FAQ can be found here.

Amendments to Form PF

On February 8, 2024, the SEC and the Commodity Futures Trading Commission jointly adopted amendments to Form PF, the confidential reporting form completed by registered private fund advisers for use by the SEC and the Financial Stability Oversight Council to monitor systemic risks to the US financial system.[10] While a significant portion of the amendments pertain to advisers to hedge funds, the amendments will require all reporting private fund advisers (including private equity fund advisers[11]) to:

- Separately report each component fund of a master-feeder arrangement and parallel fund structure, other than a disregarded feeder fund (*i.e.*, a feeder fund that invests all of its assets in a single master fund, US treasury bills, and/or cash and cash equivalents);
- Include the value of investments in other private funds (including internal and external private funds) when determining whether the adviser is required to file Form PF and whether the adviser meets certain reporting thresholds; and
- Report additional information concerning the adviser and the private funds it advises, including: (i) general identifying information; (ii) assets under management attributable to advised private funds; (iii) withdrawal and redemption rights granted to private fund investors and (iv) funds' (1) gross asset value and net asset value, (2) inflows and outflows, (3) base currency, (4) borrowings and types of creditors, (5) beneficial ownership information and (6) performance.

In addition, on May 3, 2023, the SEC adopted significant amendments to Form PF,[12] which will affect private equity fund advisers in two key ways:

- All private equity fund advisers will be required to file quarterly reports with the SEC with respect to (i) adviser-led secondary transactions; (ii) general partner removals and (iii) investor elections to terminate a fund or its investment period; and
- Large private equity fund advisers[13] will be required to provide enhanced annual reporting regarding certain activities of their private equity funds.

Quarterly Event Reporting for All Private Equity Fund Advisers

- The Form PF amendments require all private equity fund advisers to file an event report upon the occurrence of one or more trigger events within 60 days of each fiscal quarter end. Such reporting must include details of any:
  - Adviser-led secondary transaction[14] executed during the reporting period, including the transaction closing date and a brief description of the transaction; and

---

[10] The full text of the amendments' adopting release can be found here, and a related fact sheet can be found here. As under current rules, exempt reporting advisers will not be required to file Form PF as a result of the amendments.

[11] A private equity fund adviser is any adviser having at least $150 million in regulatory assets under management attributable to private equity funds as of the last day of the adviser's most recently completed fiscal year.

[12] The full text of the amendments' adopting release can be found here, and a related fact sheet can be found here. A previous alert discussing the amendments can be found here. As under current rules, exempt reporting advisers will not be required to file Form PF as a result of the amendments.

[13] A large private equity fund adviser is any adviser having at least $2 billion in regulatory assets under management attributable to private equity funds as of the last day of the adviser's most recently completed fiscal year.

[14] Adviser-led secondary transactions include any transaction initiated by the adviser or any of its related persons that offers private fund investors the choice to (i) sell all or a portion of their interests in the private fund or (ii) convert or exchange all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

- Investor election to remove a fund's general partner or to terminate a fund or a fund's investment period, including the effective date and a description of the applicable removal or termination event.

Such reporting will not be required for any quarters during which trigger events did not occur.

Enhanced Reporting for Large Private Equity Fund Advisers

The amendments add new questions to, and amend certain existing questions contained in, Form PF for large private equity fund advisers. Information solicited by these additional questions includes (but is not limited to): (i) whether any general partner or limited partner clawback occurred during the past year; (ii) whether a fund engages in fund-level borrowing, and, if so, certain details of such borrowing and (iii) the nature of any reported events of default.

Compliance Dates

The compliance date for amendments adopted on February 8, 2024 is one year after publication in the Federal Register. With respect to the amendments adopted on May 3, 2023, the compliance date for amendments relating to the new quarterly event reporting requirements for private equity fund advisers was December 11, 2023. For the amendments relating to the enhanced reporting requirements for large private equity fund advisers, the compliance date is June 11, 2024.

FTC Increases Gramm-Leach-Bliley Act Cyber Requirements

Following a 2022 amendment by the Federal Trade Commission (the "**FTC**") to the Safeguards Rule (which applies to non-banking financial institutions, including many private funds) to include substantial cyber security requirements, the FTC made further amendments in 2023 that will impose specific data breach reporting requirements.[15] The prior amendment established detailed data protection and cybersecurity criteria and imposed obligations for reporting annually to the entity's boards of directors. The 2023 amendment requires covered financial institutions to notify the FTC no later than 30 days after discovery of a security breach involving the information of at least 500 consumers. The deadline for compliance with the new amendment is May 13, 2024.

II. PROPOSED RULES

EU AI Act / White House Executive Order on AI

Lawmakers globally are actively regulating the development and use of artificial intelligence ("**AI**") technologies. On February 2, 2024, the members of the European Council unanimously agreed on the text of the proposed EU Artificial Intelligence Act, which is expected to become law this year and will regulate the development and deployment of AI systems on a risk-based classification system.[16] Coupled with the White House Executive Order on AI[17] at the end of last year, and AI-related provisions in several US state privacy laws, many businesses will find themselves subject to several different AI-related laws and regulations before the end of 2024 – not only developers of AI systems, but also businesses that leverage AI tools internally in connection with day-to-day operations.

---

[15] The full text of the FTC's final amendments can be found here.

[16] The full text of the EU proposal can be found here.

[17] The full executive order can be found here.

NY Department of Financial Services Amends Cybersecurity Regulation

On November 1, 2023, the NY Department of Financial Services ("**NYDFS**") amended its cybersecurity regulation, which will impose a number of new and enhanced governance, technical, data security, breach notification and enforcement requirements on financial institutions subject to NY State banking, insurance or financial services laws, including a requirement to report to NYDFS any payments made to cyberattackers within 24 hours of the payment.[18] The amendment will also impose certain increased cybersecurity obligations for larger companies (*i.e.*, covered entities with (i) at least $20 million gross annual revenue in each of the last two years from all business operations of the entity and business operations in NY State of its affiliates, and (ii) either (1) over 2,000 employees or (2) $1 billion gross annual revenue for global business operations of the covered entity and its affiliates). The amendment is effective April 29, 2024.

Proposed Rules to Improve Cybersecurity Risk Management

On March 15, 2023, the SEC reopened the comment period for significant new cybersecurity rules and amendments under the Advisers Act, initially proposed on February 9, 2022, which will, if adopted, apply to RIAs, private fund advisers and any other investment advisers that would not otherwise be required to register with the SEC.[19] The proposed rules and amendments are designed to enhance cybersecurity preparedness and improve the resilience of investment advisers against cybersecurity threats and attacks.

Specifically, these rules, if adopted, would require registered advisers to (i) adopt and implement written cybersecurity policies and procedures that are reasonably designed to address cybersecurity risks; (ii) report significant cybersecurity incidents to the SEC via a newly proposed Form ADV-C and (iii) create and maintain certain cybersecurity-related books and records.

The proposed rules would also enhance disclosures related to cybersecurity, including amending Form ADV Part 2A to require disclosure of cybersecurity risks and incidents.

SEC Proposed Amendments to Regulation S-P

On March 15, 2023, the SEC proposed amendments to the Safeguards Rule and Disposal Rule under Regulation S-P that will impose new detailed requirements governing how covered entities (*i.e.*, brokers, dealers, investment companies and investment advisers) protect customer information, including new requirements to provide notice of certain types of data breaches to impacted individuals within 30 days of discovery and adopt a written incident response program with specified requirements.[20] Such requirements include specified record retention periods, certain disclosures in third party agreements and accounting for remote work. The public comment period closed on June 5, 2023. The amendments are not yet effective.

SEC Proposes New Investment Adviser Safeguarding Rule to Enhance Protections of Advisory Client Assets

---

[18] The full text of the NYDFS' final amendment can be found here.

[19] The proposal regarding cybersecurity can be found here.

[20] The full proposal can be found here. A related fact sheet can be found here.

On February 15, 2023, the SEC proposed to amend and redesignate the Custody Rule to enhance investor protections relating to client assets of RIAs.[21] The amendments would redesignate the Custody Rule as new Rule 223-1 under the Advisers Act (the "**Safeguarding Rule**"). Like the Custody Rule, the Safeguarding Rule would not apply to exempt reporting advisers.

Specifically, the Safeguarding Rule, if adopted in its proposed form, would:

- Expand upon the Custody Rule's original scope of assets and activities by requiring advisers to provide certain minimum protections for "substantially all types of client assets held in an advisory account";[22]
- Require advisers with custody of client assets to maintain those assets with a qualified custodian in almost all cases and to enter into written agreements with such custodians providing certain assurances;
- Expand the Custody Rule's current privately offered securities[23] exception from the obligation to maintain client assets with a qualified custodian to also include certain physical assets, such as real estate or physical commodities (*e.g.*, wheat or lumber), and modify the conditions for relying on such exception;
- Enhance requirements of advisers with custody of client assets regarding the segregation of such assets;
- Expand the (i) requirements of the Custody Rule's surprise examination rule and (ii) annual audit exception to such rule; and
- Update related recordkeeping, notice and reporting requirements for advisers.

Proposed New Investment Adviser Outsourcing Rules

On October 26, 2022, the SEC proposed a new rule and rule amendments under the Advisers Act to prohibit RIAs from outsourcing certain services and functions without conducting due diligence and monitoring of the service providers.[24]

Under the proposal, advisers would be required to establish an oversight framework to cover functions or services that (i) are necessary for an adviser to provide its investment advisory services in compliance with Federal securities laws and (ii) if not performed, or if performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services ("**Covered Functions**").[25]

---

[21] The full text of the proposal can be found here. A previous alert discussing the proposal can be found here.

[22] The SEC stated that the Safeguarding Rule's definition of "assets" would include investments such as all crypto assets, even in the instances where such assets are neither funds nor securities. "Assets" also would encompass financial contracts held for investment purposes, collateral posted in connection with a swap contract on behalf of the client and other assets that may not be clearly funds or securities currently covered under the Custody Rule. Additionally, physical assets, including real estate or physical commodities, would be within the scope of the Safeguarding Rule. The current definition of "assets" under the Custody Rule only includes "funds and securities."

[23] Privately offered securities means securities (i) acquired from the issuer in a transaction or chain of transactions not involving any public offering; (ii) that are uncertificated, and the ownership of which can only be recorded on the non-public books of the issuer or its transfer agent in the name of the client as it appears in the records the adviser is required to keep under Rule 204-2, and (iii) that are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

[24] The SEC's proposing release can be found here. A previous alert discussing the proposed rule can be found here. The proposal is not applicable to exempt reporting advisers.

[25] Clerical, ministerial, utility and general office functions or services would be explicitly excluded from the proposed rule.

Before retaining a service provider to perform a Covered Function, an adviser would be required to reasonably identify and determine through due diligence that outsourcing the Covered Function to that service provider is, and would continue to be, appropriate.

Additionally, the proposal would require advisers to:

- Periodically monitor a service provider's performance and to reassess the selection of the service provider under the proposed rule's due diligence requirements;
- Maintain books and records related to such due diligence and monitoring; and
- Report census-type information about service providers on Form ADV.

The proposal would also require any adviser relying on a third-party recordkeeper to (i) satisfy the above due diligence and monitoring requirements with respect to such third party and (ii) obtain reasonable assurances that the third party will meet certain standards. If adopted, the proposal would require advisers to be in compliance with the rule's requirements starting ten months from the rule's effective date.

Proposed Rule to Combat "Greenwashing" and Other Misleading ESG Claims

On May 25, 2022, the SEC issued a proposal aimed at combating "greenwashing," or misleading claims by investment funds and their investment advisers regarding their environmental, social and governance ("**ESG**") credentials.[26] The proposal would, among other things, revise Form ADV to improve disclosures by advisers purporting to take ESG factors into consideration when making investment decisions. Specifically, advisers would be subject to heightened disclosure requirements relating to how ESG factors into an adviser's strategy. The proposal includes certain minimum disclosure requirements for any funds or other products that market themselves to investors as ESG-focused, as well as a requirement that ESG impact funds disclose how they measure progress on ESG goals.

III. RECENT ENFORCEMENT DEVELOPMENTS

SEC Enforcement Action Regarding Investment Adviser's Compliance Policy Failures

On December 26, 2023, the SEC settled charges against an investment adviser to private equity funds in connection with the adviser's failure to (i) maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information ("**MNPI**") and (ii) implement written policies and procedures reasonably designed to prevent misleading communications to current and prospective investors in private funds advised by the adviser.[27]

Specifically, the SEC's order noted that on numerous occasions between 2019 and 2022, certain of the adviser's senior personnel disclosed merger-related MNPI to current and prospective investors, as well as industry contacts, and also made performance-related claims to such persons in violation of the adviser's policies and procedures.

The SEC cited the adviser's actions as violations of Section 204A and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. As part of its settlement, the adviser agreed to pay a civil penalty of $4 million.

---

[26] The full proposal can be found here. A related fact sheet can be found here.

[27] A press release related to the charges is available here and the SEC's full order is available here.

This settlement reflects the SEC's continued scrutiny regarding MNPI and investor communications as well as its willingness to use violations of an adviser's internal policies as grounds for enforcement in connection with securities laws violations. In response to these charges, advisers should carefully review internal compliance policies and procedures (including those pertaining to MNPI) to ensure adherence and that such policies and procedures adequately address the adviser's compliance risks.

SEC Enforcement Actions Regarding Advisers' Violation of Whistleblower Protection Rules

On September 29, 2023, the SEC settled[28] charges against an investment adviser in connection with the adviser's violations of Rule 21F-17 under the Securities Exchange Act of 1934, as amended (such act the "**Exchange Act**", and such rules the "**Whistleblower Protection Rules**"). The Whistleblower Protection Rules prohibit any person from taking any action to impede an individual from communicating directly with the SEC about a possible securities law violation, including by "enforcing, or threatening to enforce, a confidentiality agreement. . . ." As part of the settlement, the adviser agreed to pay a $10 million penalty.

Specifically, the SEC's order noted that the adviser required new employees to sign employment agreements that prohibited them from disclosing confidential information, including any information gained through employment that could be deleterious to the adviser, to anyone outside the firm unless authorized by the adviser or required by law or an order of a court or other regulatory or governmental body. The employment agreements did not include any exception to this confidentiality provision for voluntary communications with the SEC concerning possible securities laws violations. The SEC also found that the adviser required many departing employees to sign releases that included affirmations that such employees had not filed any complaints with any governmental agency, department or official in order to receive certain deferred compensation and other benefits.

Additionally, on January 16, 2024, the SEC settled charges against another investment adviser in connection with violations of Whistleblower Protection Rules.[29] In this case, between 2020 and July 2023, the adviser frequently asked certain advisory clients and brokerage customers to whom it had issued a credit or settlement over $1,000 in value to sign a confidential release agreement that impeded such persons from disclosing potential violations of the Federal securities laws to the SEC unless responding to an inquiry from the Commission. Although the agreements permitted the clients and brokerage customers to respond to inquiries from the SEC, they did not permit voluntary communications with the Commission concerning potential securities law violations. As part of this settlement, the adviser agreed to pay an $18 million penalty.

These settlements, as well as deficiencies noted in recent examinations of advisers, evidence the SEC's focus on the Whistleblower Protection Rules. In response, advisers should carefully review their policies, employee and client agreements and any other related materials for compliance therewith.

Enforcement Action regarding Off-Channel Communications

On September 29, 2023, the SEC settled charges with five broker-dealers, three dually registered broker-dealers and investment advisers and two affiliated investment advisers with failures to maintain and preserve electronic communications records.[30]

---

[28] A press release related to the charges is available here and the SEC's full order is available here. A previous alert discussing the enforcement action can be found here.

[29] A press release related to the charges is available here and the SEC's full order is available here.

[30] A press release related to the charges is available here and the SEC's full orders are available here, here, here, here, here and here.

Specifically, the SEC's investigation uncovered that employees of all ten firms had engaged in "pervasive and longstanding off-channel communications", citing the use of personal text messages to discuss business matters and off-channel communications regarding specific investment recommendations and advice. The SEC additionally noted that each of the firms failed to maintain or preserve records of these off-channel communications, likely depriving the SEC from reviewing such communications in connection with various investigations.

Seven of the ten firms were charged with violating Section 17(a) of the Exchange Act and Rule 17a-4 thereunder and five of the ten firms were charged with violating Section 204 of the Advisers Act and Rule 204-2 thereunder. As part of the settlement, the firms agreed to pay combined penalties of $79 million.

These enforcement actions evidence the SEC's keen focus on firms' policies, procedures and practices regarding the monitoring and preservation of electronic communications and underscores the Commission's willingness to examine registrants on such topics. In response, advisers should carefully review their books and records policies against the day-to-day operations of the adviser to ensure that applicable electronic communications are being appropriately preserved.

SEC Enforcement Action Regarding Monitoring Fee Acceleration and Adviser's Fiduciary Duties Violations

On September 22, 2023, the SEC announced a settlement related to charges resulting from an investment adviser's acceleration of portfolio company monitoring fees, for transferring assets from funds nearing the end of their term to a new fund and for loaning money from one private fund to another private fund advised by an affiliate.[31]

Specifically, the SEC found that the adviser:

- Violated its (i) fiduciary duty by entering into an agreement under which it accelerated a portfolio company monitoring fee without timely disclosure to clients or investors, creating an undisclosed conflict of interest and (ii) duty of care obligations by failing to consider whether the fee acceleration was in the best interest of its clients;
- Transferred certain assets from existing funds to a newly-formed private fund that it also managed without adequately disclosing its conflicts of interest, obtaining investor consent, or allowing investors to liquidate or exit their investment at the end of the original funds' terms, locking up investor money for an additional 11 years; and
- Violated its (i) fiduciary duties by failing to adequately disclose its conflict of interest when it loaned money from one private fund it managed to a new private fund managed by an affiliated adviser and (ii) duty of care obligations by failing to undertake a process to determine if the loan was in the best interest of its clients.

The SEC's order further noted that the adviser failed to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with its receipt of compensation from portfolio companies and transfers of fund assets.

The SEC cited the adviser's actions as violations of Advisers Act Section 206(2) and Section 206(4), and Rules 206(4)-7 and Rule 206(4)-8 thereunder. As part of the settlement, the adviser agreed to pay $445,460 in disgorgement and a $1.2 million penalty.

[31] A press release related to the charges is available here and the SEC's full order is available here.

This enforcement action underscores the SEC's continued focus on monitoring fee acceleration and advisers' disclosure of conflicts of interest and duty of care obligations, signaling that such continued focus by the SEC will include review of continuation vehicles.

SEC Enforcement Action Regarding Private Equity Firm's Inadequate Disclosure of Fee Payments to an Affiliate

On September 5, 2023, the SEC announced a settlement related to charges against a real estate-focused private equity firm ("**RE Firm**") for failing to adequately disclose to investors millions of dollars of real estate brokerage fees that were paid to an affiliate. [32]

The SEC's charges stem from "certain inadequate disclosures and materially misleading statements" made by the RE Firm in connection with nearly $18 million in brokerage fees paid by one of its funds ("**RE Fund**") between 2017 and 2021 to a real estate brokerage firm owned by the RE Firm's CEO ("**RE Affiliate**"). For purposes of sourcing new investment opportunities, the RE Fund primarily relied on deal teams comprised of RE Firm employees as well as independent contractors. The costs and compensation of the deal teams were paid, in part, through a 3% brokerage fee received by RE Affiliate from the RE Fund on acquisitions sourced by the deal teams.

The SEC's order noted that the RE Fund's offering materials, including its limited partnership agreement, private placement memorandum and due diligence questionnaires, all contained misleading statements and omissions concerning fees and conflicts of interest because such materials failed to adequately disclose that RE Affiliate would receive brokerage fees. The SEC's order further noted that the RE Firm similarly failed to adequately disclose such fees and conflicts during meetings with, and in response to questionnaires and other requests for information received from, investors.

As part of the settlement, the RE Firm agreed to pay a $6.5 million penalty and more than $14 million in disgorgement and prejudgment interest. This settlement is yet another example of SEC scrutiny of relationships between investment advisers and affiliates. Advisers should carefully review all arrangements with affiliated service providers and ensure the details of such arrangements, including all fees and related conflicts of interest, are adequately disclosed to investors.

SEC Enforcement Action Regarding Advisers' Custody Rule Violations

On September 5, 2023, the SEC announced a settlement related to charges against a group of investment advisers for failing to comply with the Custody Rule.

The settlement pertains to allegations of violations of the Custody Rule by five investment advisers. The advisers failed to do one or more of the following: have audits performed; deliver audited financials to investors in a timely manner; and/or ensure a qualified custodian maintained client assets. The SEC's orders additionally cited two of the firms for failing to promptly file amended Forms ADV to reflect their receipt of audited financial statements. One firm was also cited for improperly describing the status of its financial statement audits for multiple years on its Form ADV. [33]

As part of their settlements, each of the advisers agreed to pay civil penalties ranging from $50,000 to $225,000. These settlements reflect the SEC's continuing focus on violations of the Custody Rule.

---

[32] A press release related to the settlement can be found here. The full SEC Order can be found here. A previous alert discussing the enforcement action can be found here.

[33] A press release related to the settlements can be found here. Links to the full SEC Orders for the five charged advisers can be found here, here, here, here and here. A previous alert discussing the enforcement action can be found here.

SEC Enforcement Action Regarding Adviser's Marketing Rule Violations and Compliance Failures

On August 21, 2023, the SEC announced a settlement related to charges against an investment adviser for Marketing Rule violations and numerous compliance failures.[34]

Specifically, the SEC's order noted that the adviser failed to include material information regarding hypothetical performance shown on its website (*e.g.*, that the hypothetical performance projections assumed that the strategy's performance in its first three weeks would continue for an entire year), causing such performance to be misleading. The SEC also charged the adviser with failing to adopt policies and procedures reasonably designed to ensure that the hypothetical performance shown on its website was relevant to the likely financial situation and investment objectives of prospective investors.

The adviser was additionally found to have (i) made conflicting disclosures to clients about how it custodied assets; (ii) included in its client advisory agreements liability disclaimer language that created the false impression that clients had waived non-waivable causes of action against the adviser; (iii) failed to adopt policies and procedures concerning employees' personal trading and (iv) failed to ensure that client signatures were obtained for certain types of transactions in client accounts.

The SEC cited the adviser's actions as violations of Advisers Act Section 206(2) and Section 206(4), and Rules 206(4)-1 and Rule 206(4)-7 thereunder. As part of the settlement, the adviser agreed to pay $192,454 in disgorgement, prejudgment interest and an $850,000 penalty.

This enforcement action highlights the SEC's continued review of advisers' Marketing Rule compliance and the Commission's particular scrutiny of marketing materials containing hypothetical performance. Additionally, in response to this enforcement action, advisers should carefully review (i) internal compliance policies and procedures to ensure adherence (ii) any limitations of liability contained in existing investor agreements.

SEC Enforcement Action Regarding Investment Adviser's Improper Application and Disclosure of Permanent Impairment Policy

On June 20, 2023, the SEC settled[35] charges against an investment adviser to private funds in connection with the adviser's (i) charging excess management fees due to inaccurate application of its permanent impairment policy and (ii) failing to disclose a conflict of interest to investors relating to such policy and its fee calculations. The SEC's investigation additionally revealed that the adviser did not implement written policies or procedures reasonably designed to prevent violations of the Advisers Act relating to such practices. Specifically, the SEC's order noted that the limited partnership agreements ("**LPAs**") of the adviser's funds effectively required the adviser to reduce the management fees charged to a fund should the adviser determine that a portfolio investment suffered a "permanent impairment." The adviser established criteria to determine whether a permanent impairment had occurred, but these were not disclosed to investors in the LPAs or otherwise. Additionally, in applying these criteria, the adviser analyzed permanent impairment at the "aggregated portfolio company" level rather than at the "portfolio investment" (*i.e.*, individual security) level, as required by the LPAs, resulting in the inaccurate calculation of the management fees charged to the funds (and therefore investors).

The order further noted that the adviser failed to inform investors of the impairment criteria, creating an undisclosed conflict of interest because the adviser had an incentive to minimize the existence and size of impairments in order to minimize reductions in its management fees.

---

[34] A press release related to the charges is available here and the SEC's full order is available here.

[35] A press release related to the charges is available here and the SEC's full order is available here. A previous alert discussing the enforcement action can be found here.

Weil

The SEC cited the adviser's actions as violations of Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. As part of the settlement, the adviser agreed to pay a $1.5 million penalty and $864,958 in disgorgement and prejudgment interest.

In response to this enforcement action, advisers should (i) review, and carefully adhere to, (1) any implemented impairment or write-down policies, especially with respect to fee reduction practices, and (2) the relevant provisions set forth in their fund documentation, including any distinctions between "investments" and "portfolio companies" and any interplay with write-downs and, if applicable, (ii) disclose to investors (1) all relevant criteria used in the impairment analysis and (2) the fact that the adviser has a conflict of interest in applying any subjective impairment criteria, as an impairment may reduce management fees and/or impact a fund's carried interest waterfall.

* * *

Private Funds Alert is published by the Private Funds practice of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, www.weil.com.

If you have questions concerning the contents of this alert, or would like more information about Weil's Private Funds practice, please speak to your regular contact at Weil or to the authors:

Authors

David Wohl (NY)	View Bio	david.wohl@weil.com	+1 212 310 8933
Christopher Scully (Washington, D.C.)	View Bio	christopher.scully@weil.com	+1 202 682 7119
John Bradshaw (NY)	View Bio	john.bradshaw@weil.com	+1 212 310 8535
Stephen Filocoma (NY)	View Bio	stephen.filocoma@weil.com	+1 212 310 8639

© 2024 Weil, Gotshal & Manges LLP. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations that depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list, please click here. If you need to change or remove your name from our mailing list, send an email to weil.alerts@weil.com.