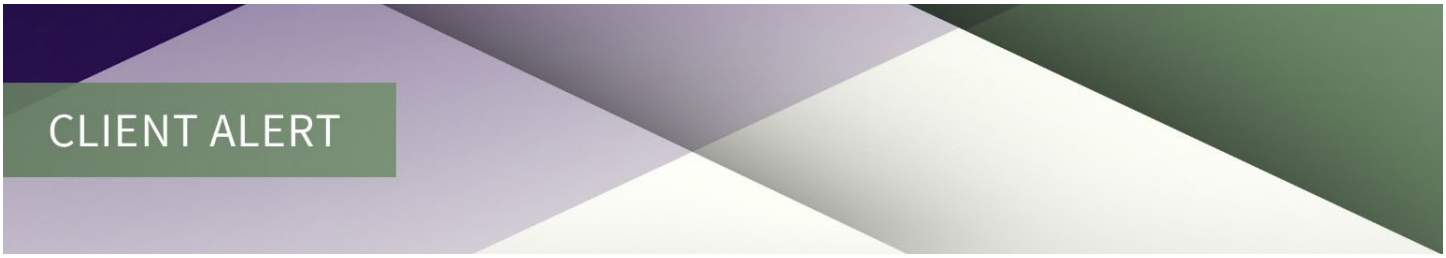

SEC Fines Private Equity Adviser for Management Fee Errors Related to Fund Loan

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On September 23, 2022, the Securities and Exchange Commission ("**SEC**") announced a settled enforcement action involving an SEC-registered investment adviser ("**the Adviser**") that allegedly failed properly to offset management fees charged to a private equity fund it managed and failed to disclose to investors and potential investors in the fund information concerning its management fees.[1] In this alert, we summarize the SEC's settlement order (the "**Order**") and discuss how the Order fits into the SEC's broader focus on private fund advisers. As this action reflects, the SEC's interest in private fund adviser fee and expense issues—a perennial concern for nearly a decade—remains intense. Interestingly, this most recent management fee-related enforcement action arises from a loan from the fund to the adviser. Such loans would be expressly prohibited if a pending proposed rule is adopted.

Background

The Adviser was formed in 2008 and registered with the SEC in 2020. It provides advisory services to 12 pooled investment vehicles. From May 2018 through October 2020, the Adviser borrowed nearly $1.1 million from a private equity fund that it managed in order to pay placement agent fees to a third-party vendor. The offering and governing documents for the relevant fund and its affiliated vehicles required prompt repayment of the loan through an offset of the quarterly management fees the Adviser charged the fund. The Adviser did not offset any of the money borrowed from the fund against management fees for 11 consecutive quarters. In addition, from July 2018 to October 2021, the Adviser

[1] *See In the Matter of Wave Equity Partners LLC*, Investment Advisers Act Release No. 6146 (Sept. 23, 2022), available here.

never informed investors or potential investors in the fund that it had failed timely to repay the loan. The Adviser completed repaying the loan in full with interest in October 2021.

Violations, Sanctions, and Remediation

The Order found that the Adviser's conduct violated Section 206(2) of the Advisers Act, which makes it unlawful for an investment adviser to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which make it unlawful for an investment adviser to a pooled investment vehicle to engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor. The Order imposed a cease-and-desist order, a censure, and a $325,000 penalty upon the Adviser. The Order further noted that, in determining to accept the Adviser's offer of settlement, the SEC considered the Adviser's remedial efforts, including fully repaying the loan with interest, hiring a new chief compliance officer, engaging an outside compliance consultant, and convening a management committee charged with providing stringent and timely oversight of the compliance program by senior management.

Takeaways

This enforcement action is consistent with the acute focus across the SEC on advisers to private funds, including with respect to conduct that predates their SEC registration. Both the SEC Chair and the Director of the SEC's Division of Enforcement have spoken about the importance of private funds.[2] The SEC's Division of Examinations identified private funds as the first significant area of focus in its 2022 Examination Priorities and specifically mentioned fee and expense issues.[3] Finally, the SEC has instituted other enforcement actions arising from private fund management fee errors over the past year.[4]

In addition, the SEC has proposed an unprecedented number of new rules that, if adopted, will have significant effects on private fund advisers, including the proposed new rules and amendments under the Advisers Act that would prohibit certain practices of private fund advisers and impose certain reporting requirements (the "**Private Fund Adviser Rule**").[5] In fact, the loan that ultimately led to the management fee error in the Order would be prohibited if the proposed Private Fund Adviser Rule is adopted.[6] The Order is at least the second SEC enforcement action involving a private fund this

2 *See, e.g.*, SEC Chair Gary Gensler, Prepared Remarks at the Institutional Limited Partners Association Summit (Nov. 10, 2021), available here; SEC Enforcement Director Gurbir Grewal, Press Release re SEC Enforcement Action (Feb. 17, 2022), available here.

3 SEC Division of Examinations, 2022 Examination Priorities at 11, available here.

4 *See, e.g.*, *In the Matter of Energy Innovation Capital Management, LLC*, Investment Advisers Act Release No. 6104 (Sept. 2, 2022), available here.

5 *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Advisers Act Release No. 5955 (Feb. 9, 2022). For a discussion of the proposed changes, please see the Willkie Farr & Gallagher LLP Client Alert, available here.

6 *See* Proposed Rule 211(h)(2)-1(a)(7) under the Advisers Act, which would prohibit a private fund adviser from borrowing money, securities, or other private fund assets, or receiving a loan or an extension of credit, from a private fund client.

year arising from a practice that would be prohibited under the proposed Private Fund Adviser Rule.[7] The SEC's enforcement actions involving conduct that would be prohibited by proposed rulemaking may be referenced by the SEC as support for the Private Fund Adviser Rule in a future adopting release and may suggest future enforcement actions involving practices that would be prohibited by proposed rules.

The Order is the latest reminder that investment advisers to private funds, including private fund advisers that are not registered with the SEC, should be prepared for SEC scrutiny, particularly with respect to fees and expenses. Special attention to the disclosure concerning management fee calculations and to the adoption and implementation of policies and procedures around management fee calculations can mitigate the regulatory risk in this frequent area of SEC interest.

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[7] *See In the Matter of Energy Capital Partners Management, LP*, Investment Advisers Act Release No. 6049 (June 14, 2022) (enforcement action arising from undisclosed non-*pro rata* allocation of financing expenses between fund and co-investment vehicle), available here, *and* Proposed Rule 211(h)(2)-1(a)(6) under the Advisers Act, which would prohibit a private fund adviser from charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a non-pro rata basis when multiple private funds and other clients advised by the adviser or its related persons have invested (or proposed to invest) in the same portfolio investment.