Updates
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The SEC's Continued Focus on Private Fund Advisers

The U.S. Securities and Exchange Commission (SEC) recently settled enforcement actions against two private equity fund advisers within days of each other. Both actions involved violations of the Investment Advisers Act of 1940 (Advisers Act) stemming from material omissions in marketing materials and failures to disclose conflicts of interest with respect to paid services provided to portfolio companies. These two cases highlight the SEC enforcement staff's attention to private equity fund advisers, particularly regarding compliance policies, marketing materials, conflicts of interest, and adequate disclosure of fees and expenses.

Old Ironsides Energy

On April 17, 2020, the SEC announced a settlement with Boston-based private equity manager Old Ironsides Energy, LLC (OIE) for allegedly using misleading information when marketing its private fund and failing to implement its own compliance policies. In settling with the SEC, OIE agreed to pay a penalty of $1,000,000.

OIE, an investment adviser registered with the SEC since 2013, marketed the Old Ironsides Energy Fund II LP (Fund) to investors between March 2014 and April 2015, stating that the Fund would only invest in direct drilling investments (DDIs), private equity investments, and midstream assets such as pipelines. The marketing materials stated that the investment strategy of the Fund would **not** include investing in other private funds. However, according to the SEC, OIE's marketing materials identified a "large, legacy investment with strong, positive returns as an early stage [DDI]" without notifying investors "it was actually an investment in a private fund advised by a third party." In addition, the SEC determined that OIE failed to implement its policies prohibiting marketing materials from omitting information necessary to avoid materially misleading information.

The SEC concluded that, by omitting material information from its marketing materials, OIE willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) under the Advisers Act, which make it a fraudulent, deceptive or manipulative act, practice, or course of business to, among other things, directly or indirectly publish, circulate, or distribute an advertisement which contains any untrue statement of material fact, or which is otherwise false or misleading. The SEC also found that OIE willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 under the Advisers Act, which requires a registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act.

Monomoy Capital Management

On April 22, 2020, the SEC settled with New York-based private equity manager Monomoy Capital Management, L.P. (Monomoy) for failing to disclose that it charged portfolio companies of a private fund it managed for the services of the firm's in-house "Operations Group," which helped make business improvements to portfolio company operations. In settling with the SEC, Monomoy agreed to pay $1,926,579 in investor reimbursements and penalties.

Monomoy, registered with the SEC as an investment adviser since 2012, advises several private funds, including Monomoy Capital Partners II, L.P., MCP Supplemental Fund II, L.P., and Monomoy Capital Partners AIV II,

L.P. (collectively, Fund II). Since 2007, Monomoy has provided Fund II's portfolio companies with operational and financial consulting services from its in-house "Operations Group," which included Monomoy employees and contractors who helped manage the operations of, and make improvements to, the portfolio companies. Monomoy billed these services to the portfolio companies at an hourly rate. The SEC order stated that Monomoy emphasized the value added by its Operations Group in generating investment returns, but failed to provide "full and fair disclosure" to Fund II's investors sufficiently specific that they could understand the conflicts of interest and have a basis on which they could consent to or reject the practice.

Prior to 2014, Monomoy did not disclose anything about the Operations Group providing billable services to Fund II's portfolio companies, or about any reimbursement that Monomoy would receive, or had received, from portfolio companies to cover the cost of such services. While Monomoy disclosed that portfolio companies were responsible for paying Monomoy certain fees, it did not mention the Operations Group or disclose that Monomoy would receive compensation-related fees for its Operations Group from portfolio companies. In March 2014, Monomoy's Form ADV disclosed that "under specific circumstances, certain Monomoy operating professionals may provide services to portfolio companies that typically would otherwise be performed by third parties," and that "Monomoy may be reimbursed" for costs related to such services. These disclosures, the SEC noted, did not "fully and fairly" disclose the fact that Monomoy routinely provided such services; that it did, in fact, receive reimbursements from portfolio companies for such services; and that the reimbursement rates were designed to recoup most (but not all) of Monomoy's costs of maintaining its Operations Group.

The SEC found that Monomoy willfully violated Section 206(2) of the Advisers Act, which prohibits investment advisers from engaging "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." The SEC's order acknowledged Monomoy's cooperation, including voluntarily and promptly providing documents and information, meeting with the SEC staff on multiple occasions, and providing detailed factual summaries of relevant information.

Takeaways

- **"May" Is Not a Panacea for Disclosing Conflicts:** The SEC and the staff have been clear—disclosure that an adviser "*may*" have a particular conflict, without more, is *not adequate* when the conflict actually exists (or will).[1] The SEC has said that an adviser should not use "may" to simply precede a list of all possible or potential conflicts regardless of likelihood; this muddles the actual conflicts to the point that a client cannot provide informed consent.[2]
- **Follow Your Compliance Policies:** An investment adviser must adopt and *implement* policies and procedures reasonably designed to prevent violations of the Advisers Act from occurring. While policies and procedures are a starting point, merely having them without proper implementation and annual testing of their effectiveness is not enough and compliance failures are sure to occur.[3]
- **Disclosures of Fees and Expenses and Conflicts Are a Recurring Focus of the SEC Staff:** The SEC staff is consistently reviewing advisers' disclosures of fees and expenses.[4] The SEC's Office of Compliance Inspections and Examinations (OCIE) 2020 Examination Priorities state that "OCIE will review [advisers] to private funds to assess compliance risks, including controls to prevent . . . conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses, and the use of . . . affiliates to provide services to client."[5] To this end, during exams, examiners will review a fund's offering documents and financial statements for inconsistencies between what is disclosed and what fees and expenses the fund is actually incurring. Examiners will also inquire into the existence and disclosure of potential conflicts of interest and whether the adviser's disclosure and mitigation of such conflicts are consistent with the adviser's policies and procedures, fund offering documents, and its fiduciary duty.[6]
- **Do as You Say:** It is important for an investment adviser to implement and follow every obligation disclosed in a private fund's offering materials. If there are any material changes to or deviations from how

the adviser operates the private fund, the adviser should promptly update the offering materials and notify investors or seek to amend.

- **Cooperation Can Make a Difference:** In examination and enforcement matters, the staff and the SEC often take into account an adviser's cooperation with the staff.[7]
- **SEC Private Fund Unit:** In 2014, OCIE created a Private Funds Unit dedicated to examining private fund advisers, including private equity advisers. Advisers can expect that, when warranted, the Private Funds Unit will refer matters to the SEC's Division of Enforcement for further investigation and possible enforcement proceedings.[8]

ENDNOTES

[1] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248, at 25 (June 5, 2019) (Interpretation), *available at*: https://www.sec.gov/rules/interp/2019/ia-5248.pdf. The SEC has brought enforcement actions in such cases. *See, e.g.*, *In the Matter of The Robare Group, Ltd.*, Investment Advisers Act Release No. 4566 (Nov. 7, 2016) (SEC Opinion) (finding, among other things, that an adviser's disclosure that it *may* receive a certain type of compensation was inadequate because it did not reveal that the adviser actually had an arrangement pursuant to which it received fees that created a conflict of interest); *aff'd in relevant part by Robare Group v. SEC*, 922 F.3d 468 (D.C. Cir. 2019) (denying petition challenging the SEC's finding that the Petitioners violated Section 206(2) of the Advisers Act). *See also SEC v. Westport Capital Markets*, slip op. (D. Conn. Sept. 30, 2019) (the adviser's Form ADVs "warned clients that [the adviser and its principal] *might* be deriving additional compensation from their trading activities on the clients' behalf . . . [but] did not advise the clients that they were *actually* doing so, much less how they were specifically doing so by [,among other things,] . . . garnering 12b-1 fees from mutual fund transactions") (emphasis in original).

[2] Interpretation at 25. The SEC has warned advisers that *longer* disclosures may not be *better* disclosures. *See* SEC, Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation, https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation.

[3] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Feb. 5, 2004), *available at*: https://www.sec.gov/rules/final/ia-2204.htm ("Each adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct promptly any violations that have occurred . . . in designing its policies and procedures…[an adviser] should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks.").

[4] *See* U.S. Securities and Exchange Commission 2020 Examination Priorities, *available at*: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf; *see also* OCIE, Examination Priorities for 2015 ("Given the high rate of deficiencies that we have observed among advisers to private equity funds in connection with fees and expenses, we will continue to conduct examinations in this area"), *available at*: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf; *see also* Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers, National Exam Program Risk Alert (Apr. 12, 2018), *available at*: https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.

[5] *See* Office of Compliance Inspections and Examinations 2020 Examination Priorities, *available at*: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[6] *See, e.g., In the Matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C.*, Investment Advisers Act Release No. 4219 (Oct. 7, 2015) (settling charges against three Blackstone private equity fund advisers for a $39 million penalty because of, among other things, failure to adequately disclose the acceleration of monitoring fees paid by fund-owned portfolio companies prior to the companies' sale or initial public offering), *available at*: https://www.sec.gov/litigation/admin/2015/ia-4219.pdf.

[7] *See* SEC Spotlight on Enforcement Cooperation Program, *available at*: https://www.sec.gov/spotlight/enforcement-cooperation-initiative.shtml.

[8] *See* Marc Wyatt, Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), *available at*: https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html (the Private Funds Unit "is dedicated to examining advisers to private funds, including private equity advisers" and its "mission is to apply industry and product knowledge to conduct focused, risk-based examinations using OCIE's limited resources. The Private Funds Unit plays a critical role in targeting and selecting exam candidates, scoping risk areas, executing examinations, and analyzing data gleaned from those examinations.")

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