

## **CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT: A SPECIAL REPORT FOR PRIVATE FUNDS**

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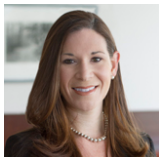
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## CURRENT DEVELOPMENTS IN SEC EXAMINATIONS & ENFORCEMENT: A SPECIAL REPORT FOR PRIVATE FUNDS

Morgan Lewis’s securities enforcement and investment management teams highlight expected US Securities and Exchange Commission (SEC or Commission) priorities for private fund managers in 2022 and look back at SEC private fund enforcement matters from the last year. If you have an investment adviser focus, we encourage you to review our [companion piece directed to investment advisers](#).

As we pass the one-year anniversary of Chairman Gary Gensler’s tenure at the SEC, it is clear that he has made private funds a priority. Already, Chair Gensler has signaled a willingness to take on longstanding industry norms such as the “two and twenty” fee structure, and an intention to act aggressively against misconduct in the private funds space. The newly issued 2022 Examination Priorities make clear that, given the “size, complexity, and significant growth of this market,” private fund advisers will remain a focus of the Division of Examinations.<sup>1</sup>

After the SEC spent the last several years focused on “Main Street” retail misconduct that left private funds largely out of the SEC’s crosshairs, Chairman Gensler and his staff seem intent on shifting that focus in a way that is certain to affect hedge and private equity fund managers.

## GENERAL SEC ENFORCEMENT OUTLOOK

### Speed Traps Ahead, Fines May Be Doubled

It took Gurbir Grewal, the new SEC director of enforcement, little time to remind the defense bar of enforcement analogies from the past, such as “broken windows.” On October 6, 2021, two months into his tenure, Director Grewal announced:

[O]ne thing I know is that if you post a 65 mile-per-hour speed limit and don’t enforce it, people drive 75. Not me, of course, but other people. And they eventually do so with a sense of impunity. And then after a while they will drive 80 or faster, with a growing sense of confidence. As speeds climb higher and higher, you eventually have situations where accidents increase and heightened enforcement follows. But for all of the victims, it’s too late. It’s a stark analogy, but the point is that we are not waiting for accidents to happen.<sup>2</sup>

Translation? Expect this SEC to be more willing to pursue and penalize basic violations—writing more 70 MPH speeding tickets—in areas such as recordkeeping and periodic filing requirements.



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Further, there is an unabashed willingness to engage in regulation by enforcement or, in other words, to bring enforcement cases in an attempt to affect overall industry conduct. As Chair Gensler recently stated:

A cop on the beat has to balance both the high-impact cases and the everyday fraudsters. A high-impact case pulls many other actors back from the line. This prompts legal alerts, client letters, and bulletins to go out. Compliance departments, lawyers, and accountants change internal procedures as well. Such high-impact cases are important. They change behavior. They send a message to the rest of the market, to participants of various sizes, that certain misconduct will not be permitted. Some market participants may call this “regulation by enforcement.” I just call it “enforcement.”<sup>3</sup>

Necessary to this approach will be a coordinated effort to bring various enforcement tools to bear, and Messrs. Grewal and Gensler have expressed a willingness to do so aggressively.

## Civil Penalties

We expect increased civil penalties in the coming months, which may be untethered to past precedent. SEC Commissioner Caroline Crenshaw fired the first salvo in the recent discussion of penalties to promote deterrence, noting, “[W]e can’t look only at the impact the penalty will have on a particular group of investors who own shares in the specific violating entity. . . . We must think about the impact on all investors, and that will help ensure fair and efficient markets.”<sup>4</sup> Director Grewal took this a step further, cautioning that “to achieve the intended deterrent effect, it may be appropriate to impose more significant penalties for comparable behavior over time,” and “while penalties levied in the past are certainly a relevant data point for our conversations, you should not expect comparable cases to be the beginning and end of our analysis.”<sup>5</sup> A recent \$125 million settlement for violations of recordkeeping requirements illustrates this approach.<sup>6</sup>

## The Wells Process

The involvement of senior enforcement officials in the Wells process has been an important aspect of defending clients before the Commission. Often these meetings allow for a fresh look and perspective that may be lacking with the investigators and supervisors who have been living with a case for years. With the stated goal of “Trusting and Empowering SEC Staff,” Director Grewal explained that, absent a novel legal or factual issue, parties will not have access to the director or deputy director.<sup>7</sup> Further, the Commission will be limiting the number of White Paper submissions made prior to any Wells process to address issues of delay. This discussion serves to emphasize the importance of engaging early and at the staff level with the Commission.

## Admissions

Both Chair Gensler and Director Grewal recently noted that admissions were back in the Enforcement Division’s toolbox of remedies because “[w]hen it comes to accountability, few things rival the magnitude of wrongdoers admitting that they broke the law, and so, in an era of diminished trust, we will, in appropriate circumstances, be requiring admissions in cases where heightened accountability and acceptance of responsibility are in the public interest.”

## Self-Reporting of Violations

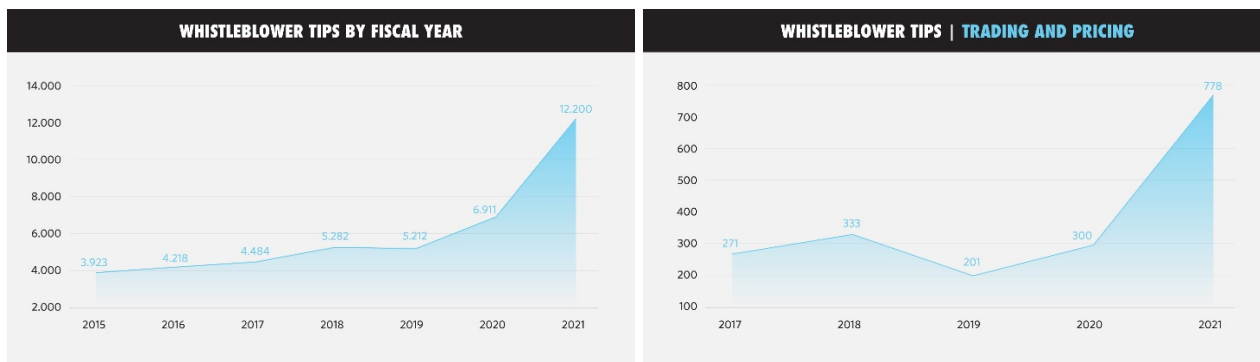
In the past, through initiatives such as the Municipalities Continuing Disclosure Cooperation Initiative and the recent Share Class Selection Disclosure Initiative, the Division of Enforcement has leveraged limited resources into numerous actions through self-disclosure. We expect similar efforts in the coming year, including with regard to cyberincident disclosure.<sup>8</sup> New private fund reporting and disclosure

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requirements, discussed below, are consistent with this general approach. In the recordkeeping case described above, Director Grewal took this approach one step further, admonishing registrants to “scrutinize their document preservation processes and self-report failures such as those outlined in today’s action before we identify them.”<sup>9</sup>

## Whistleblowers

In fiscal year 2021, the Commission awarded approximately \$564 million to 108 whistleblowers, the largest dollar amount and the largest number of individuals awarded in a single fiscal year.<sup>10</sup> These record amounts demonstrate the maturation of the program as actions aided by whistleblower tips are moving to resolution and resulting in awards. Further, a constant stream of press releases announcing whistleblower awards apparently has driven dramatic growth, as new whistleblower tips increased by 76% year-over-year from 6,911 in 2020 to 12,210 in 2021.<sup>11</sup> Given that whistleblower awards can only be paid to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in monetary sanctions of more than \$1 million, the effect of hundreds of eligible whistleblowers on the Enforcement program has been, and will continue to be, dramatic.



## 2021 RECAP

### Private Fund Enforcement and Regulatory Developments

Since taking office in April 2021, Chair Gensler has been clear about his intention to pursue reforms that may tighten the SEC’s control over the private funds industry and pursue enforcement actions against private fund managers. This would bring a marked departure from Jay Clayton, the SEC chairman during most of the Trump administration, who trained the SEC staff’s sights almost exclusively on matters affecting retail investors and who relaxed certain rules to the benefit of private funds.

### 2021 Regulatory Initiatives

Chair Gensler, in contrast, has openly targeted private funds for reforms that could negatively impact their business. For example, he noted in a speech in November 2021 the need for “more sunshine and competition” in the private funds industry.<sup>12</sup> He has also questioned whether the SEC has done enough to protect investors in private funds, raising the possibility of new rules regarding private fund fees and the use of side letters. Chair Gensler expressed his concern that different fee structures and the use of side letters “create an uneven playing field among limited partners” in which “similar pension plans consistently pay different private equity fees.”

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The SEC has indicated that it intends to follow through on these initiatives. A Regulatory Agenda<sup>13</sup> published by the SEC shows that its staff in the Division of Investment Management is actively considering, among other things:

- rules to address “lack of transparency, conflicts of interest, and certain other matters involving private fund advisers”;
- amendments to Form PF, which advisers to private funds use to report certain information to the SEC;
- amendments to Regulation D and Form D “to improve protections for investors”; and
- updating the financial thresholds in the accredited investor definition, and other amendments to the rules relating to exempt offerings.

Already in 2022, we have seen the SEC move aggressively to promote this agenda. In January 2022, the SEC proposed amendments to Form PF, the confidential reporting form for certain SEC-registered investment advisers to private funds, including reporting that would give the SEC near real-time visibility into the investment activities of private funds.<sup>14</sup> For a detailed discussion of the proposed amendments, look to this Morgan Lewis LawFlash, [SEC Proposes Sweeping New and Amended Rules Under Advisers Act to Overhaul Private Fund Industry](#). More recently, on February 9, the SEC proposed new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) to require private fund advisers to provide investors with quarterly statements detailing certain information regarding fund fees, expenses, and performance.<sup>15</sup>

The proposed rules also prohibit private fund advisers, including those not registered with the SEC, from providing certain types of preferential treatment to investors in their funds and all other preferential treatment unless it is disclosed to current and prospective investors. The practices that would be prohibited outright include preferential redemption rights and access to information about portfolio holdings if the adviser reasonably expects those rights to “have a material, negative effect on other investors.” Should the SEC adopt those rules and follow through on its other initiatives—particularly those that address transparency and conflicts—it will represent a seismic shift in how the SEC regulates the private funds industry.

## 2021 Enforcement Actions Involving Private Funds

For the SEC’s Enforcement Division, 2021 was a continuation of a multiyear focus on retail investors, which left many private funds off the Enforcement staff’s radar. In 2021, the Enforcement Division staff, including staff in its Asset Management Unit, remained focused on draining the pipeline of cases built up over former Chair Clayton’s tenure, including cases involving mutual fund share class selection, assorted mutual fund revenue-sharing conflicts, and other retail-oriented cases such as improperly assessed advisory fees. In doing so, cases involving private fund managers remained at the low end of the average over the last 10 years.

### *Conflicts*

The limited number and types of cases against advisers to hedge and private equity funds in 2021 reflected the SEC’s continued focus on conflicts. For example, the SEC charged a private fund adviser with investing fund assets in a company managed by a close relative of the adviser’s chief investment officer without making sufficient disclosure to fund investors.<sup>16</sup> In another matter, the SEC charged an adviser to private funds and a business development company (BDC) with collecting due diligence fees on loans made to portfolio companies without making adequate disclosures to the BDC’s board of directors about the conflicts inherent in the receipt of those fees.<sup>17</sup>

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## *Management Fee Offsets*

The SEC's 2021 private fund enforcement actions also included a case involving a failure to apply management fee offsets in accordance with the funds' offering documents.<sup>18</sup> In that case, the documents stated that the adviser would offset fund-level management fees against portfolio company fees paid to the adviser, but the adviser failed to fully apply the required offsets. The offering documents for two funds advised by the manager also contained discrepancies regarding the calculation of management fees.

## *Material Nonpublic Information*

Finally, the SEC charged an adviser that provided investment options exclusively to current and former partners and employees of a global consulting company with failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information (MNPI), as required by Section 204A of the Advisers Act.<sup>19</sup> The adviser's investment committee included partners of the consulting company who had access to MNPI, but the SEC alleged that the adviser failed to adopt policies and procedures designed to address the risk that those board members would have such MNPI at the time they were overseeing and monitoring the adviser's investments. This action is yet another in a series of cases that the SEC has brought against private fund advisers in recent years for violating Section 204A of the Advisers Act.

## **2022 ENFORCEMENT AND EXAMINATION TRENDS**

### **Examination Priorities**

On March 30, 2022, the Division of Examinations issued its 2022 Examination Priorities. From an enforcement perspective, registrant examinations continue to be a significant source of enforcement investigations through referrals. During FY 2021, Examinations completed 3,040 exams, issued more than 2,100 deficiency letters, and made more than 190 referrals to Enforcement.

Given that Enforcement typically opens approximately 900 investigations a year, exam referrals account for a significant amount of enforcement investigative activity and exam priorities are a leading indicator. We expect the SEC's enforcement focus on private funds to intensify in 2022 and beyond, particularly given the aggressive rulemaking that the SEC is proposing.

While we wait for the proposed and anticipated rules to make their way through the rulemaking process, how might the staff in the SEC's Division of Enforcement and Division of Examinations follow through on this more aggressive regulatory agenda in the coming year? We anticipate these divisions will focus on the following types of conduct:

1. **Fees and Expenses.** Although this is an area that the SEC's Enforcement and Examinations staffs have targeted for years, we expect them to apply even greater scrutiny to them now, and perhaps in novel ways. Given Chairman Gensler's questioning of different fee structures and the use of side letters, we could see the Enforcement staff questioning whether a lack of transparency about fees or disclosures regarding the different fees that similarly situated investors pay rise to the level of a securities law violation. The recently issued 2022 Examination Priorities note that exams will continue to review "the calculation and allocation of fees and expenses, including the calculation of post-commitment period management fees and the impact of valuation practices at private equity funds." To date, the SEC has not pursued cases based on the mere existence of side letters and preferential terms, and it should be careful about doing so given the unquestioned ability of advisers and their clients—particularly sophisticated institutional investors in private funds—to negotiate the terms of their arrangements. Nevertheless, the SEC staff is likely to seek to push the envelope in advance of



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potential rules in order to highlight what may be seen as the detrimental impact of such arrangements.

2. **SPACs.** The wave of SPAC mergers in 2020 and 2021 has already given rise to enforcement actions and numerous reports of additional investigations. In the private funds space, we anticipate that the Enforcement and Examinations staffs will scrutinize SPACs sponsored by private fund managers or their affiliates, and how those SPAC offerings and de-SPAC transactions were conducted. Among other things, we expect the SEC staff to analyze how a manager who sponsors a SPAC or is affiliated with a sponsor handled any conflicts of interest associated with the transaction and allocated shares in the SPAC, including PIPE offerings, to private fund clients.
3. **Insider Trading.** Insider trading in the hedge fund space has long been a focus of the SEC's Division of Enforcement, and a recent case involving "shadow trading" could signal a new line of inquiry. In *SEC v. Panuwat*,<sup>20</sup> the SEC pursued a novel insider-trading claim against a defendant who bought call-option contracts in a competitor company after learning that an acquisition of his employer, which was likely to have a positive impact on the competitor's stock price, was imminent. This type of "shadow trading"—trading in the stock of one company to which the defendant has no relationship based on anticipated market reaction to news about another company to which the defendant owes some duty of confidentiality—has not previously been addressed by federal courts. Already, however, the court in *Panuwat* has denied the defendant's motion to dismiss, finding that information can be material to more than one company.<sup>21</sup> It is not hard to imagine the SEC staff looking at hedge fund and private equity fund managers, who often have access to nonpublic information about portfolio companies that might impact the stock price of competitors.



In addition, the 2022 Examination Priorities note a focus on alternative data sources. "[T]o the extent that firms are using alternative data or data gleaned from non-traditional sources as part of their business and investment decision-making processes, reviews will include examining whether RIAs, including RIAs to private funds and registered funds, are implementing appropriate compliance and controls around the creation, receipt, and use of potentially MNPI."<sup>22</sup>

4. **"Broken Windows" or "Speeding Ticket" Cases.** In an October 6, 2021, speech, Director Grewal warned that the SEC is looking to "address emerging risks before they cause harm to investors," and pointed to enforcement actions against a number of firms that failed to deliver Forms CRS to clients and customers timely.<sup>23</sup> Expect focus on recordkeeping obligations and other requirements imposed on private fund managers, particularly those that might impact the SEC's regulatory functions, such as Form PF and Section 13 filings, or information available to clients and investors, such as Form ADVs.
5. **Environmental, Social, and Governance (ESG) and Marketing.** With the growing investor demand for ESG strategies, we can expect the SEC to focus examination and enforcement resources on review of ESG-related disclosures both in fund offering documents and in marketing materials. While the SEC did not file any enforcement actions specifically relating to ESG matters in 2021, Chair Gensler has spoken frequently about his concerns relating to greenwashing, most recently in a video



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post to Twitter raising the question whether funds have sufficient substance underpinning their ESG claims. In 2022 the Division of Examinations will continue to focus on whether advisers are “accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures, including review of their portfolio management processes and practices.” Finally, the SEC is poised to issue rulemakings in this area, and the SEC staff will certainly look to those issuances for guideposts for their reviews and investigations in this area.

6. **Risk Management Controls and Disclosures.** The onset of the COVID-19 pandemic in early 2020 brought extreme volatility to global securities markets. Many funds, particularly those that invested in volatility-linked instruments, were impacted by these events. As with many similar events, we expect the SEC’s Enforcement and Examination staffs to focus on funds that pursued such strategies to determine whether their investments were consistent with disclosures to investors. The SEC staff is also likely to analyze whether risk management techniques employed by those advisers matched their representations to investors.
7. **Valuation.** Similarly, and consistent with past SEC initiatives, we expect the Enforcement and Examination staffs to focus on the valuation of complex investments, including those based on volatility and that were held during the first months of the pandemic. The staff will likely scrutinize managers who claimed outsize performance based on those investments, as well as managers who may have downplayed losses.

The coming months promise to be active as the initiatives signaled by the Gensler administration at the SEC flow through to the Enforcement and Examinations staffs at the Commission.

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# Morgan Lewis

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<sup>1</sup> See SEC Division of Examinations, [2022 Examination Priorities](#), at 12 (Mar. 30, 2022).

<sup>2</sup> Gurbir Grewal, SEC Director of Enforcement, [Remarks at PLI Broker/Dealer Regulation and Enforcement Conference 2021](#) (Oct. 6, 2021).

<sup>3</sup> Gary Gensler, SEC Chairman, [Remarks at the Securities Enforcement Forum](#) (Nov. 4, 2021).

<sup>4</sup> Caroline A. Crenshaw, SEC Commissioner, [Moving Forward Together – Enforcement for Everyone](#) (Mar. 9, 2021).

<sup>5</sup> Gurbir Grewal, SEC Director of Enforcement, [Remarks at PLI Broker/Dealer Regulation and Enforcement Conference 2021](#) (Oct. 6, 2021).

<sup>6</sup> Press Release, Securities and Exchange Commission, [JPMorgan Admits to Widespread Recordkeeping Failures and Agrees to Pay \\$125 Million Penalty to Resolve SEC Charges](#) (Dec. 17, 2021).

<sup>7</sup> Gurbir Grewal, SEC Director of Enforcement, Remarks at SEC Speaks 2021 (Oct. 13, 2021).

<sup>8</sup> Securities and Exchange Commission, [In the Matter of Certain Cybersecurity-Related Events \(HO-14225\) FAQs](#) (June 25, 2021).

<sup>9</sup> Press Release, Securities and Exchange Commission, [JPMorgan Admits to Widespread Recordkeeping Failures and Agrees to Pay \\$125 Million Penalty to Resolve SEC Charges](#) (Dec. 17, 2021).

<sup>10</sup> Securities and Exchange Commission, [Whistleblower Program 2021 Annual Report to Congress](#) (Nov. 15, 2021).

<sup>11</sup> *Id.*

<sup>12</sup> Gary Gensler, SEC Chairman, [Remarks at the Institutional Limited Partners Association Summit](#) (Nov. 10, 2021).

<sup>13</sup> [SEC Agency Rule List – Fall 2021](#).

<sup>14</sup> Press Release, Securities and Exchange Commission, [SEC Proposes Amendments to Enhance Private Fund Reporting](#) (Jan. 26, 2022).

<sup>15</sup> Press Release, Securities and Exchange Commission, [SEC Proposes to Enhance Private Fund Investor Protection](#) (Feb. 9, 2022).

<sup>16</sup> *SEC v. Diastole Wealth Management, Inc. et al.*, [Advisers Act Release No. 5855](#) (Sept. 10, 2021).

<sup>17</sup> Press Release, Securities and Exchange Commission, [SEC Charges Investment Adviser with Taking Unapproved and Undisclosed Fees](#) (June 4, 2021).

<sup>18</sup> Press Release, Securities and Exchange Commission, [SEC Charges Private Equity Fund Adviser with Fee and Expense Disclosure Failures](#) (Nov. 19, 2021).

<sup>19</sup> Press Release, Securities and Exchange Commission, [McKinsey Affiliate to Pay \\$18 Million for Compliance Failures in Handling of Nonpublic Information](#) (Dec. 20, 2021).

<sup>20</sup> Press Release, Securities and Exchange Commission, [SEC Charges Biopharmaceutical Company Employee with Insider Trading](#) (Aug. 17, 2021).

<sup>21</sup> *SEC v. Panuwat*, Order Denying Mot. to Dismiss, ECF No. 26, No. 3:21-cv-6322-WHO (N.D. Cal. Jan. 14, 2022).

<sup>22</sup> 2022 Examination Priorities, at 17.

<sup>23</sup> Gurbir Grewal, SEC Director of Enforcement, [Remarks at PLI Broker/Dealer Regulation and Enforcement Conference 2021](#) (Oct. 6, 2021).