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Client Alert

Investment Management

May 21, 2024

SEC Settlement Reflects Continued Scrutiny Regarding Conflicts and Preferential Treatment

By Jeremy Cantor, Jimmy Kang, and Scott H. Moss

On May 14, 2024, the U.S. Securities and Exchange Commission (SEC) announced a settlement with a registered investment adviser (Adviser) that found the Adviser had (a) failed to adequately disclose conflicts pertaining to compensation linked to fund investments that were received by the Adviser's principal (Principal) and (b) improperly provided preferential treatment related to withdrawals.[1]

Background

The Fund's and the SMA's Film Investments

The Adviser advised several separately managed accounts (SMAs) and a private investment fund (Fund) that primarily invested in film and television projects. The Fund's portfolio consisted of interest-bearing loans the Fund extended to film production companies.

Beginning in 2017, the Adviser and the Principal contracted with a film studio (Film Studio A) and a production company (Production Company A), pursuant to which the Adviser and Principal agreed they would invest the assets of the SMAs and the Fund "exclusively in film projects offered by Film Studio A and financed by Production Company A." Furthermore, the Adviser and Principal "caused all film loans made by the Fund and the SMAs to be made only to either Production Company A directly or to a joint venture between Film Studio A and Production Company A."

Thereafter, the Fund began to make loans to Production Company A in exchange for Production Company A paying a fixed interest rate on those loans. The Adviser and Principal caused the SMAs to do the same.

Principal's Receipt of Executive Producer Compensation

During the period examined and unbeknownst to Fund investors and the SMAs' holders, the Principal directly contracted with Film Studio A to receive certain compensation as an executive producer for films in which the Fund and the SMAs made investments, which equated to a portion of the financing the Principal directed from the Fund and the SMAs to Production Company A and the above-mentioned joint venture. The Principal (through a holding company) ultimately received compensation via this contract but "did not distribute any of this compensation to the Fund, its limited partners, or the SMAs whose investments had enabled [the Principal] to obtain this compensation."

Adviser and Principal Failed to Disclose the Material Conflict of Interest Resulting from the Principal's Receipt of Executive Producer Compensation

Initially, neither the offering documents of the Fund nor the SMAs contained any disclosure about the aforementioned compensation, much less any disclosure regarding associated conflicts. Yet, when disclosure was later added regarding the receipt of such compensation, the SEC stated that "these disclosures were materially misleading because they either stated or implied that the executive producer fees paid to [the Principal] were unrelated to his clients' investments." More specifically, the disclosure omitted that the Principal's executive producer compensation was exclusively tied to the funds loaned by the Fund and the SMAs to Production Company A, rather than any non-investment-related production activities. Additionally, the disclosure falsely claimed that the Principal's executive producer compensation was not derived from client investments.

Adviser and Principal Improperly Preferenced the Withdrawal of a Limited Partner

According to the Fund's limited partnership agreement, limited partners that wanted to withdraw their interests (a) were required to give at least 90 days' notice and (b) had their withdrawals capped at 50% of their investment on a quarterly basis.

As Production Company A began defaulting on its loan payments to the Fund, it became more difficult for the Fund to satisfy withdrawal requests in full. In these instances, the Fund would generally satisfy these requests partially by distributing available cash pro rata to withdrawing investors.

However, in one event, the Fund deviated from its general practice of pro rata withdrawals and gave preferential withdrawal rights to one investor (Investor A) in full, ahead of other withdrawal requests (which were left unfulfilled).[2] This preferential treatment was neither disclosed to nor consented to by Fund investors. Furthermore, "[i]nvestors whose redemption requests were not prioritized were left to bear the market risk of the Fund's remaining assets, and certain of these investors were unable to exit the Fund following its suspension of all withdrawals from limited partner capital accounts in September 2021."

Violations

As settled, the Adviser and the Principal were found to have willfully violated Section 206(2) and Section 206(4) of the Investment Advisers Act of 1940, as amended. As a result, the Adviser and the Principal were respectively ordered to pay a $200,000 and $150,000 civil money penalty. After adding disgorgement and prejudgment interest, the Principal's ultimate penalty amount was approximately $778,000.

Takeaways

This settlement is an important (but not unforeseeable) reminder that the SEC continues to focus on investment advisers (and the funds they advise) with respect to conflicts of interest,[3] client/investor disclosure, and preferential treatment (in this case, withdrawals).[4]

As is generally the case, advisers should first ensure that their governing documents permit a desired activity (in this case, for example, (i) lending by advisory clients and (ii) outside activities by and compensation to the Principal). As the SEC noted, some of the conduct here (i.e., granting an investor a preferential withdrawal right to the expected benefit of the Fund and the Adviser but to the disadvantage of other investors) was contrary to the relevant Fund's limited partnership agreement (which called for pro rata withdrawal rights). As such, advisers must ensure that their activities conform to a client's governing documents, especially when their activities could provide preferential rights to certain investors at the expense of other investors or their activities could pose a material conflict of interest. Even after ensuring that advisers are following (or at least acting consistent with) a client's governing documents, when granting preferential treatment or where a material conflict of interest of the adviser exists, advisers must also be aware of the fiduciary duty they owe to clients and investors therein. First, preferential treatment and material conflicts should be fully and fairly disclosed to clients/investors. Full and fair disclosure could necessitate the disclosure of specific facts and not just vague descriptions of circumstances or future possibilities. Second, even if certain material conflicts or preferential treatment is disclosed with specificity, such activity may still require some type of client/investor consent (for example, from SMA holders, investors, a limited partner advisory committee, or another independent representative of investors) even if the governing documents do not require it as a result of the inherent fiduciary duty (which cannot be waived).

Preferential treatment is a particularly relevant topic as advisers await the effective date of the Preferential Treatment Rule. Under such a rule, advisers must disclose, and in certain instances offer to other investors, certain preferential rights offered to one or more investors. The Preferential Treatment Rule also contains a grandfathering provision, which prevents advisers from having to offer up certain preferential treatment rights to other investors where such rights existed prior to the effective date of the Preferential Treatment Rule. With respect to preferential withdrawals, however, advisers should exercise caution when attempting to grandfather preferential withdrawal provisions ahead of the effective date of the Preferential Treatment Rule given the fiduciary duty issues raised in this settlement.

Next Steps

For further information, guidance, and clarity on how advisers can approach and tailor their fund documents and sufficiently disclose conflict matters, and for assistance in reviewing certain transactions from a conflicts perspective, please reach out to the authors of this article or directly to your regular Lowenstein Sandler contact.

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[1] https://www.sec.gov/files/litigation/admin/2024/ia-6603.pdf.

[2] "Investor A was a portfolio manager at a large private equity firm who, [the Principal] believed, might dissuade others in the industry from investing with [the Adviser] and/or initiate litigation against [the Adviser] if Investor A's [withdrawal] request was not timely honored in full."

[3] *See* e.g., https://www.sec.gov/files/2024-exam-priorities.pdf (one area of the SEC's focus will be conflicts of interest).

[4] *See* e.g., https://www.lowenstein.com/news-insights/publications/client-alerts/the-sec-s-private-fund-adviser-rules-explained-part-2-the-preferential-treatment-rule-im. As part of the SEC's 'Private Funds Rules,' once effective, there will be certain restrictions around granting any preferential withdrawal rights to investors.

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