

Investment Management

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The Importance of Complying with Private Fund Documents for Affiliate Transactions

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Executive Summary

Private fund advisers continually balance their ongoing responsibility to ensure that the funds they advise comply with such funds' governing documents and their responsibility to ensure their own compliance with applicable law and fiduciary duties.

A particular area of focus within a fund's governing documents relates to transactions between the fund and its affiliates—which may create conflicts of interest for the fund. Often, private fund advisers see potential synergies in having funds they advise contract with affiliated service providers for various transactions or other items. For purposes of this client alert, we concentrate on certain terms within a fund's governing documents that pertain specifically to affiliate transactions.¹ To do so, we examine a risk alert by the Division of Examinations (Division), formerly known as the Office of Compliance Inspections and Examinations, and three related Securities and Exchange Commission (SEC) settlements.

The Division on Arm's-Length Affiliate Transactions

While complying with relevant law is critical for private funds, so is complying with such funds' governing documents. On June 13, 2020, the Division released a risk alert (Risk Alert) flagging certain observations made by the Division in various examinations of private fund advisers.² In the Risk Alert, the Division emphasized that some private fund advisers failed to comply with requirements in their governing documents regarding transactions with affiliated service providers. Specifically, private fund advisers represented to investors that transaction terms with affiliated service providers would be no less favorable than those with unaffiliated third parties. However, such private fund advisers lacked proper procedures to establish whether such services provided by affiliates of the fund were comparable to or more cost-effective than services offered by unaffiliated third parties.³

The SEC on Arm's-Length Affiliate Transactions

In addition to the Division's Risk Alert, the SEC has released multiple enforcement actions, across several administrations and SEC chairpersons, that emphasize proper compliance with a fund's governing documents as it relates to affiliate transactions, some of which we explore below.

In September 2024, the SEC settled with an investment adviser (Adviser 1) for, among other things, its failure to comply with a fund's governing documents with respect to affiliate transactions. Specifically, the fund's limited partnership agreement required that transaction terms with affiliates be as favorable as those with qualified independent third parties. Upon examination, the SEC found that the fund's limited partnership agreement was violated because Adviser 1 did not establish proper procedures to verify whether the fund's transactions with affiliate service providers were comparable to those with unaffiliated third parties. Additionally, Adviser 1 failed to assess whether these transactions complied with the fund's limited partnership agreement.⁴

Relatedly, in November 2016, the SEC settled with another investment adviser and its affiliates (Adviser 2) for improperly and intentionally using affiliates as intermediaries for investment purchases contrary to the limited partnership agreement of one of the funds it advised. Again, this fund's limited partnership agreement required that affiliate transactions of the fund be on terms no less favorable than transactions made with unrelated third parties. However, in violation of the fund's governing documents, the fund's general partner intentionally entered into affiliate transactions that had less favorable terms than those offered by unrelated third parties.⁵

Lastly, the SEC settled with another investment adviser in 2013 (Adviser 3) because Adviser 3 did not properly assess an affiliate transaction pursuant to its funds' operating agreements. The fund's operating agreement provided that the fund could only engage in an affiliate transaction if the "terms [are] no less favorable than those terms which could be obtained between [the fund] and independent third parties dealing at arm's-length." However, the SEC found that Adviser 3 acted contrary to its operating agreement and intentionally entered into affiliate transactions with knowledge that the transaction terms were less favorable than terms offered by independent third parties.⁶

Takeaways

The Risk Alert and the three SEC settlements serve as a caution for investment advisers to ensure that any affiliate transactions entered into by any fund they advise properly comply with all requirements in its fund's governing documents. Advisers should also ensure they document such compliance with the fund's governing documents and any applicable law (including, but not limited to, an adviser's fiduciary duties to its clients)⁷ and that they have appropriate related policies and procedures for affiliate transactions (and, if applicable, compliance with the applicable provisions in the governing documents). As noted herein, for example, if a fund's governing document notes that affiliate transactions cannot be made on less favorable terms than those offered by an unaffiliated third party, the adviser should ensure that it actually determines what those terms are and document such determination.

Next Steps

For further information, guidance, and clarity on the terms of your governing documents as well as proper compliance documentation and policies and procedures for affiliate transactions, please reach out to the authors of this article or your regular Lowenstein Sandler contact directly.

¹ Note that this alert does not examine compliance with principal and/or cross-transaction requirements. See, e.g., <https://www.lowenstein.com/news-insights/publications/client-alerts/sec-identifies-common-principal-and-agency-cross-trading-compliance-deficiencies-investment-management>.

² https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

³ *Id.*

⁴ <https://www.sec.gov/files/litigation/admin/2024/ia-6671.pdf>.

⁵ <https://www.sec.gov/files/litigation/admin/2016/33-10250.pdf>.

⁶ <https://www.sec.gov/files/litigation/admin/2013/33-9401.pdf>.

⁷ See, e.g., <https://www.sec.gov/files/rules/interp/2019/ia-5248.pdf>.

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