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Insights

RECENT SEC ENFORCEMENT ACTION INTEGRATING AFFILIATED ADVISERS

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A recent Securities and Exchange Commission ("SEC") settled enforcement action serves as an excellent reminder of the risk of operational integration to firms that operate multiple advisory entities, especially where one of those entities claims an exemption from registration. Depending on the degree of operational integration, the SEC may treat them both as a single adviser, thus jeopardizing the exemption and exposing the firm's entire advisory structure to enforcement.[1]

In the most recent enforcement action, two separate affiliated advisory entities were at issue. One was a registered investment adviser and the other claimed the private fund adviser exemption.[2] The SEC concluded that the exempt adviser did not qualify for this exemption because it had operational and ownership overlap with the SEC-registered affiliated adviser.

Aspects of their operational and ownership integration cited in the enforcement action included:

- operation out of the same offices, with no physical separation;
- sharing the same email domain and phone number;
- lack of policies or procedures to keep affiliates separate or protect disclosure of investment advisory information from one affiliate to another;
- common IT systems;
- common owners and executives;
- other common significant personnel, including those who provided investment advice.

The exempt adviser was also sanctioned for failure to comply with the Advisers Act custody rules applicable to registered advisers. In the settlement, the adviser agreed to demonstrate its compliance with the custody rules, cease and desist from further violations and pay a civil penalty of $45,000. We attribute the relatively small penalty to the SEC's acknowledgment that the adviser exercised prompt remedial actions, including steps to reorganize its operations and separate its

advisory functions from its affiliate, as well as its adoption of policies and procedures designed to comply with applicable rules.

Prior to this most recent enforcement action, the most notable SEC actions regarding operational integration pertained to the TL Ventures and Penn Mezzanine settlements in June 2014. TL Ventures had claimed that it was exempt from SEC registration under the exemption available to investment advisers solely to venture capital funds[3], and Penn Mezzanine, an affiliate of TL Ventures, had claimed it was exempt from SEC registration under the private fund adviser exemption.

Similar to the ACP enforcement action, the SEC found that the firms were integrated through their operations and ownership and therefore not entitled to the venture capital fund adviser or private fund adviser exemptions.

TL Ventures was also cited for failure to comply with the "pay to play" rules. TL Ventures and Penn Mezzanine were both censured and agreed to cease and desist from further violations, and TL Ventures agreed to pay a civil penalty of approximately $250,000. The SEC noted that it had taken into account TL Ventures' and Penn Mezzanine's remedial actions, including steps to reorganize their operations and separate their advisory functions, as well as their adoption of policies and procedures designed to comply with applicable rules.

These enforcements action serve as a pointed reminder of the critical importance of segregating operations and ownership of affiliated advisers that seek to take advantage of the private fund adviser or venture capital fund adviser exemptions. They also illustrate the potential benefit of remedial action when dealing with the SEC enforcement staff.[4]

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[1] See ACP Venture Capital Management Fund LLC, ("ACP") (Sept. 20, 2024); TL Ventures Inc., SEC Release No. IA-3859 ("TL Ventures"); Penn Mezzanine Partners Management, L.P., SEC Release No. IA-3858 (June 20, 2014).

[2] See Section 203(m) of the Investment Advisers Act of 1940, as amended.

[3] See Section 203(l) of the Investment Advisers Act of 1940, as amended.

[4] See SEC Press Release, Eleven Firms to Pay More Than $88 Million Combined to Settle SEC's Charges for Widespread Recordkeeping Failures (Sept. 24, 2024).

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