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Insights

PREFERENTIAL TREATMENT OF PRIVATE FUND INVESTORS: COMMON SEC ENFORCEMENT PATTERNS

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EXECUTIVE SUMMARY

Following the Fifth Circuit's 2024 vacatur of the SEC's Private Fund Rules[1], registered investment advisers must again rely on enforcement precedent to understand prohibited preferential treatment practices. Our analysis of key SEC enforcement actions reveals seven critical violation patterns: (1) secret early redemption rights, (2) improper valuation advantages, (3) undisclosed side deals, (4) inconsistent notice periods, (5) deliberately delayed redemptions, (6) reputation-based preferential treatment, and (7) affiliate favoritism. All cases involved undisclosed preferential treatment that harmed or potentially harmed other investors. Penalties have ranged from cease-and-desist orders to multi-million dollar fines and industry bars. The consistent enforcement principle is clear: any preferential treatment that is undisclosed, misleading, or harmful to investors may very well violate federal securities laws.

INTRODUCTION

The Securities and Exchange Commission ("SEC") has long used enforcement actions to challenge certain preferential treatment of investors by private fund sponsors as violations of anti-fraud provisions under the Investment Advisers Act of 1940 (the "Advisers Act").[2] In 2023, the SEC adopted the Private Funds Rules, which, in part, explicitly prohibited private fund advisers from giving investors preferential redemption or information rights that materially harm other investors.[3] The Fifth Circuit Court of Appeals vacated these rules in their entirety in 2024 on grounds that the SEC exceeded its statutory authority under the Advisers Act in adopting them.[4] Without these rules in place,[5] practitioners must again rely on historical SEC enforcement actions for guidance on prohibited preferential treatment.

We have conducted a review of the SEC enforcement actions to document the specific types of preferential treatment that have consistently resulted in regulatory violations and significant penalties, including those actions explicitly cited in the releases for the now-vacated Private Fund Rules. These enforcement actions reveal clear patterns of prohibited conduct that all private fund advisers should understand and avoid to minimize regulatory risk and civil liability.

These actions consistently involve findings that advisers breached their fiduciary duties by putting their own interests or the interests of favored investors ahead of their obligations to all investors. All of the enforcement actions we reviewed involved situations where preferential treatment was not properly disclosed to affected investors. The SEC consistently emphasizes that investors must be fully informed of any preferential redemption rights granted to other investors.

The SEC also tends to focus on cases where preferential treatment causes or has the potential to cause material harm to other investors, whether through increased market risk, delayed redemptions, or unfair valuation impacts.

KEY PROHIBITED PRACTICES

1. Secret Early Redemption Rights

The Problem: Granting certain investors the ability to exit funds early without disclosing this possibility to other investors. In *Schwendiman Partners* (2002)[6], the adviser allowed two investors to exit a fund in liquidation at current value while leaving remaining investors to bear market risk of unsold securities. The SEC found this "breached their fiduciary duty to advisory clients" by putting the adviser's interests ahead of clients.

2. Improper Valuation Advantages

The Problem: Allowing select investors to withdraw at favorable valuations that disadvantage remaining investors. The *Joseph W. Daniel* case (2005)[7] involved a hedge fund manager who permitted certain investors to make withdrawals "at improper valuations to the disadvantage of the remaining investors."

3. Undisclosed Side Deals and Liquidity Arrangements

The Problem: Making secret agreements that provide preferential liquidity terms to select investors. The high-profile *Harbinger Capital/Phillip Falcone* case (2013)[8] involved a number of allegations of misconduct, including side deals with large investors providing "preferential liquidity terms via oral agreements and side letters" without disclosure to the fund's board or other investors. Even though no favorable redemptions were actually granted, the mere potential for material negative effects on non-favored investors was sufficient for SEC charges in this case.

4. Inconsistent Redemption Notice Periods

The Problem: Applying different redemption notice requirements to different investors without proper disclosure. In *Aria Partners* (2018)[9], the adviser had an informal policy allowing certain investors partial redemptions with significantly less than the required 90-day notice, while others were held to the full period. Some of this disparate treatment was due to "employee error," highlighting the need for proper procedures.

5. Deliberately Delaying Redemptions

The Problem: Intentionally slowing or obstructing redemption requests from certain investors while processing others normally. *Deccan Value Investors* (2022)[10] involved an adviser that delayed large redemption requests by placing portions in special purpose vehicles and misrepresenting fund liquidity, even when sufficient liquid assets were available.

6. Reputation-Based Preferential Treatment

The Problem: Prioritizing redemptions based on the investor's potential to harm the adviser's business reputation. In *Hudson Valley Wealth Management* (2024)[11], the adviser prioritized one investor's redemption over others because the investor was "a portfolio manager at a large private equity firm who, the adviser believed, might dissuade others in the industry from investing with the advisor and/or initiate litigation."

7. Affiliate Favoritism in Redemption Timing

The Problem: Allowing affiliated investors to redeem with shorter notice periods than disclosed to unaffiliated investors. *Galois Capital Management* (2024)[12] permitted certain investors, including those affiliated with the adviser, to redeem with less than five business days' notice while disclosing a different policy to other investors.

COMPLIANCE BEST PRACTICES

Based on these enforcement patterns, private fund advisers should implement the following compliance measures:

- **Comprehensive Disclosure**: Fully disclose all preferential terms regarding redemption or information rights to all investors before they invest.
- **Consistent Application**: Apply redemption terms, notice periods, and valuation methodologies consistently across all investors and in accordance with contractual requirements and internal policies and procedures.
- **Written Policies and Procedures**: Establish clear, written policies and procedures for redemption processing, including escalation procedures for unusual requests and documentation requirements for any deviations.
- **Regular Training**: Train staff on proper redemption procedures to avoid "employee error" situations that have led to enforcement actions.
- **Impact Assessmen**t: Before granting any preferential treatment, assess whether it could materially harm other investors and document the analysis.

PENALTY TRENDS AND RISK ASSESSMENT

SEC penalties for preferential treatment violations have escalated significantly over time. Early cases like *Schwendiman Partners* (2002) and *Joseph W. Daniel* (2005) resulted primarily in cease-and-desist orders and injunctions. However, more recent cases involve substantial monetary penalties and, in egregious cases like *Harbinger Capital* (2013), industry bars and penalties exceeding $18 million. Advisers should expect increasingly severe penalties, particularly where preferential treatment involves large dollar amounts, affects numerous investors, or demonstrates a pattern of misconduct.

KEY TAKEAWAY

The overarching principle from these enforcement actions is clear: any preferential treatment that is undisclosed, misleading, or harmful to investors may very well violate federal securities laws. Investment advisers must ensure full transparency, consistent application of fund terms, and careful consideration of the impact on all investors when making any decisions that could be construed as preferential treatment. A fuller treatment of each of the above-referenced enforcement actions follows.

APPENDIX

SEC Enforcement Actions Involving Preferential Treatment of Private Fund Investors

In the Matter of Schwendiman Partners, LLC, Securities Act Release No. 8111, Investment Advisers Act Release No. 2043 (July 11, 2002).

In this settled administrative enforcement action, Schwendiman Partners LLC was a private fund adviser that was equally owned by two individuals and was in the process of liquidation. Before all of the securities in the fund had been sold, the fund adviser granted two investors a discretionary waiver to exit the fund early at its then-current value because the investors had agreed to invest in another similar fund advised by the same adviser. The fund's remaining investors were left to bear the market risk of the assets remaining in the fund. This preferential treatment allowed the early-redeeming investors to exit the fund to the detriment of the remaining investors, who were not afforded the same redemption rights and were unaware that other investors would be granted any preferential redemption rights when they invested. The SEC found the preferential treatment the adviser granted to the investors who exited early "breached their fiduciary duty to advisory clients, demonstrating a pattern of . . . putting their own interests ahead of advisory clients." The fund adviser and its owners agreed to cease and desist from violations of Advisers Act Sections 206(1) and Section 206(2).

SEC v. Joseph W. Daniel, Litigation Release No. 19427 (Oct. 13, 2005)

In this civil action, the SEC alleged that Joseph Daniel, the managing general partner of the investment adviser for a hedge fund, engaged in improper practices in the management of the fund, including allowing certain investors to make withdrawals from the hedge fund at inflated valuations to the disadvantage of the remaining investors. Daniel consented to the entry of a judgment that enjoined him from violations of Sections 206(1) and 206(2) of the Advisers Act.

SEC v. Phillip A. Falcone, Harbinger Capital Partners Offshore Manager, L.L.C. and Harbinger Capital Partners Special Situations GP, L.L.C., Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.) and SEC v. Harbinger Capital Partners LLC, Philip A. Falcone and Peter A. Jenson, Civil Action No. 12 Civ. 5028 (S.D.N.Y.), Litigation Release No. 22831A (Oct. 2, 2013)

This was a civil action settled by consent judgment in which the SEC, among other things, alleged violations of Advisers Act Sections 206(1) and 206(2) and Sections 206(4) and Rule 206(4)-8. Harbinger Capital Partners LLC, controlled by Phillip Falcone, served as adviser to several funds, including Harbinger Capital Partners Fund I which was governed by a board of directors. As a result of investment losses in 2008, many investors were seeking to redeem their interests in this fund. To stabilize the situation, the adviser sought to change the fund's "gate". To implement a change to the gate, the adviser needed to obtain consent of two thirds of the investors by the terms of the fund's governing documents. Fearing that it would be unable to obtain such consent, the adviser made side deals with some of the fund's largest investors, providing preferential liquidity terms via oral agreements and side letters.

In entering into these side deals, the adviser did not disclose certain terms that would have been significant to the fund's board of directors and failed to honor Most Favored Nation provisions with certain investors. The side deals further contained terms that would have been significant to the non-favored investors. While there was not evidence any favorable redemption was in fact granted, the potential for such material negative effect of the non-favored investors was sufficient for the SEC to charge Falcone and the adviser. This granting of preferential redemption terms was deemed particularly egregious because Falcone improperly borrowed $113.2 million from the fund to pay his personal tax obligation at a time when Falcone had barred other fund investors from making redemptions. Falcone did not disclose the loan to investors for approximately five months.

In the settlement, Falcone and the adviser admitted wrongdoing. As a result of these and other securities law violations, Falcone was subject to an industry bar, and he and the adviser were required to pay multi-million dollar penalties.

In the Matter of Aria Partners GP, LLC, Investment Advisers Act Release No. 4991 (Aug. 22, 2018)

In this settled administrative enforcement action, Aria Partners was the investment adviser to a private fund governed by a limited partnership agreement that required 90 days' written notice for redemptions. However, the fund had an informal policy, only disclosed to certain investors, which allowed certain investors to request partial redemptions on significantly less than the specified

notice period. Over the years, the fund processed several partial redemption requests in less than 90 days. In addition, some investors were granted full redemptions on 60 days' notice, while other investors were held to the 90 days' notice period. This disparate process was in some cases due to employee error, and these practices resulted in materially different redemption amounts for investors depending on when the adviser permitted the redemptions. Aria Partners agreed to cease and desist from violating Advisers Act Section 206(4) and Rule 206(4)-8.

In the Matter of Deccan Value Investors LP, et al., Investment Advisers Act Release No. 6079 (Aug. 3, 2022)

This is another settled administrative enforcement action addressing differing redemption practices for different investors. Deccan Value Investors LP, the adviser to a private fund, was notified that two of the fund's largest investors wanted to redeem their entire investment. The adviser, balking at the significant amount of the redemption and apparently concerned over the negative impact the redemptions could have on non-redeeming investors, sought to slow the redemptions.

For investor one, the adviser took the unprecedented step of redeeming 90% of the requested amount on the redemption date but placing 10% in a limited special purpose vehicle. The adviser did not work to redeem the remaining 10% of the investment by the requested redemption date even though it had ample time to liquidate fund assets. The adviser redeemed the remaining 10% unreasonably slowly and well after the requested redemption date.

For investor two, the adviser represented to the investor that there were not sufficient liquid investments to satisfy the redemption request. In actuality, the adviser had received offers to liquidate the fund's interest in a fund investment that would have been sufficient to satisfy investor two's redemption request. The adviser rejected these offers and delayed the investor's redemption.

While delaying the redemption requests of the two investors, the adviser misrepresented the liquidity of the fund and the fund's ability to honor the redemptions to the investors. The adviser further internally discussed ways to unreasonably delay the redemptions.

On these facts, the SEC found that the adviser breached its fiduciary duty, and the adviser agreed to cease and desist from violations of Advisers Act Section 206(4) and Rule 206(4)-8.

In the Matter of Hudson Valley Wealth Management, Inc. and Christopher Conover, Investment Advisers Act Release No. 6603 (May 14, 2024).

Hudson Valley Wealth Management, Inc, the adviser to a private investment fund, and its principal, Christopher Conover, agreed to settle this administrative enforcement action in which the SEC made the following findings. The fund's limited partnership agreement stated that limited partners who wish to redeem their investments in the fund were required to give at least 90 days' notice. When the fund lacked the liquidity to satisfy a number of redemption requests, the adviser directed

the fund to redeem a single investor in full ahead of other simultaneously submitted redemption requests from other fund investors, including those who were also pre-existing clients of the adviser. The adviser redeemed one investor over others because the redeemed investor was a portfolio manager at a large private equity firm who, the adviser believed, might dissuade others in the industry from investing with the advisor and/or initiate litigation against the adviser if its redemption request was not honored.

Neither the adviser nor its principal disclosed this preferential treatment to the other investors or obtained their consent. Investors whose redemption requests were not prioritized were left to bear the market risk of the fund's remaining assets, and certain of those investors were negatively impacted because they were unable to exit the fund following its suspension of all withdrawals from limited partner capital accounts. The SEC found that the adviser breached its fiduciary duties to its clients and investors in the fund and the adviser agreed to cease and desist from violation of Advisers Act Section 206(2) and Section 206(4) and Rule 206(4)-8.

In the Matter of Galois Capital Management LLC, Investment Advisers Act Release No. 6670 (Sept. 3, 2024).

This is a settled administrative enforcement action based on differing redemption practices for different investors. Galois Capital Management LLC was a registered investment adviser for a private fund that was governed by a limited partnership agreement that required 30 days' written notice for fund investors to redeem their interests, unless a shorter notice period was approved by the fund's general partner that was controlled by the adviser. The adviser had an informal practice of permitting redemptions with at least five business days' notice before month end, which was communicated to some of the investors. However, the adviser allowed certain other investors, including investors affiliated with the adviser, to redeem with less than five business days' notice. The SEC found that this practice of permitting certain investors to redeem with less than five business days' notice while disclosing a different redemption policy and practice to other investors was misleading. Although the enforcement action order did not directly state that the adviser's redemption practices harmed investors, investor losses can be fairly inferred since the SEC did state that the approximately half of the fund's assets had been lost as the result of the collapse of a crypto firm investment and established a Fair Fund for distribution to unaffiliated investors. As a result of this conduct, the adviser agreed to cease and desist from violations of Advisers Act Section 206(4) and Rule 206(4)-8.

[1] *National Association of Private Fund Managers v. Securities and Exchange Commission*, No. 23-60471, (5th Cir.) (June 5, 2024). See also, BCLP Client Alert, SEC Adopts Long-awaited Final Rules for Private Fund Advisers (Aug. 15, 2023); BCLP Client Alert, Fifth Circuit Court of Appeals Vacates the SEC's Private Fund Adviser Rules (June 6, 2024).

[2] 15 U.S.C. § 80b-6; 17 C.F.R. § 275.206(4)-8.

[3] *See* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-6368 (Aug. 23, 2023) (the Adopting Release) *available at* https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.

[4] *Supra* note 1.

[5] The 90-day deadline for seeking Supreme Court review lapsed on September 3, 2024, without the SEC filing a petition. The SEC also did not seek *en banc* review at the Fifth Circuit (the deadline for which was July 22, 2024).

[6] In the Matter of Schwendiman Partners, LLC, Securities Act Release No. 8111, Investment Advisers Act Release No. 2043 (July 11, 2002).

[7] SEC v. Joseph W. Daniel, Litigation Release No. 19427 (Oct. 13, 2005).

[8] SEC v. Phillip A. Falcone, Harbinger Capital Partners Offshore Manager, L.L.C. and Harbinger Capital Partners Special Situations GP, L.L.C., Civil Action No. 12 Civ. 5027 (PAC) (S.D.N.Y.) and SEC v. Harbinger Capital Partners LLC, Philip A. Falcone and Peter A. Jenson, Civil Action No. 12 Civ. 5028 (S.D.N.Y.), Litigation Release No. 22831A (Oct. 2, 2013).

[9] In the Matter of Aria Partners GP, LLC, Investment Advisers Act Release No. 4991 (Aug. 22, 2018).

[10] In the Matter of Deccan Value Investors LP, et al., Investment Advisers Act Release No. 6079 (Aug. 3, 2022).

[11] In the Matter of Hudson Valley Wealth Management, Inc. and Christopher Conover, Investment Advisers Act Release No. 6603 (May 14, 2024).

[12] In the Matter of Galois Capital Management LLC, Investment Advisers Act Release No. 6670 (Sept. 3, 2024).

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