The Investment Lawyer

Covering Legal and Regulatory Issues of Asset Management

VOL. 31, NO. 6 • JUNE 2024

SEC Regulatory Liability of Third-Party Fund Service Providers: A Hard Look Back and a Cautious Glimpse Forward—Part 2

By Leslie Cruz

In Part 1 of this article, which appeared in the May 2024 issue of *The Investment Lawyer*, we explored Securities and Exchange Commission (SEC) enforcement proceedings against Registered Fund administrators (in 2006, 2013 and 2015), a Private Fund administrator (in 2016) and a Registered Fund custodian bank (in 2016). In this second part, we continue our exploration, first turning back to a 2018 enforcement proceeding against a Registered Fund administrator.

The Registered Fund Administrator and the Fake Fund Assets (2018)[1]

The administrator in this 2018 proceeding served as administrator for a particular Registered Fund for approximately three years. At the core of this case is the Fund's net asset value per share (NAV) calculation. Under the administration agreement, the administrator was responsible for, among other things, calculating NAV and transmitting it to the Nasdaq securities exchange for public consumption. The SEC stated that for about a year and a half, the NAV that the administrator provided to Nasdaq was inflated because the administrator included in the NAV fake assets that were purportedly worth over $15 million but actually had no value (as they were fake . . .).

But here's the rub—the SEC admitted that the administrator *did not know* that the assets were fake at the time of the NAV calculations. What the administrator did know, however, is that for months the Fund's custodian did not have adequate proof of the existence of many of the assets, and as a result the custodian *did not include these assets as Fund assets,* resulting in significant discrepancies (for example, approximately $7M) between the administrator's and the custodian's records (and to boot the administration agreement required the administrator to perform reconciliations with the Fund custodian). In fact, the custodian bank explicitly informed the administrator that the custodian bank could not book these loans as Fund assets because the Fund's investment adviser had not yet provided the bank with the underlying loan documents. Nevertheless, the administrator continued to include these loans in the NAV calculation.

When the administrator discovered the discrepancy, it did not take any further steps, such as, by way of the examples that the SEC cited, further investigating the assets, notifying the investing public or the Fund's board that the custodian bank did not have proof of the validity of the assets, or reducing the NAV accordingly.

As it turns out, the underlying problem started at the very beginning of the administrator's tenure as such, when the principal of the Fund's investment adviser began misappropriating Fund assets by creating fictitious loans originated through an entity controlled by the principal. The fictitious loans were designated on the Fund's books and records with a special code, and were significantly larger in dollar value than the loans that the Fund typically acquired. The principal instructed the Fund's custodian bank to wire out Fund assets to acquire these purported loans, and then diverted those amounts to his personal and business bank accounts. At the end of the administrator's tenure, the principal was arrested and charged with criminal securities fraud by the US Attorney's Office for the District of Massachusetts. Approximately one month later, the SEC filed a civil securities fraud action against the principal, the adviser and others.

The SEC found that the administrator was a cause of the Fund adviser's violations of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (Advisers Act), and ordered the administrator to, among other things, pay a civil monetary penalty of $400,000, and pay disgorgement and interest of just over $160,000. In addition to reinforcing the comparative nature of regulatory responsibility, similar to the two 2016 proceedings, this proceeding highlights that even if another party, even one that has a greater degree of responsibility and duty owed to the Fund and its shareholders as compared to a mere third-party Fund administrator, commits fraud, a Fund administrator that effectively turns a blind eye to material inconsistencies can be found to have caused the Fund's violation of the federal securities laws.

But Fund administrators are not the only type of third-party Fund service providers on which the SEC has focused enforcement efforts, as demonstrated by a proceeding involving a Fund custodian bank just a year later.

The Registered Fund Custodian Bank and the Undisclosed Up-Charges (2019)[2]

The Fund custodian bank in this proceeding is the same bank that was the subject of the 2016 proceeding previously summarized, and served as the custodian for thousands of Registered Funds for years. Echoing the prior proceeding, in this one the SEC again noted that the custodial services agreements with the Funds required the custodian bank to create and maintain records relating to the Funds' activities under the custodial agreement in a manner that would meet the Funds' obligations under the Investment Company Act of 1940 (1940 Act), including Section 31 and Rules 31a-1 and 31a-2. In some cases, the custodian had also contracted with the Funds to provide accounting services, which included maintaining journals of, among other things, Fund expenses, calculating fixed and variable expenses, and calculating expense caps and expense reimbursements (which becomes relevant).

The agreements also of course set out the compensation arrangements, which included payment to the bank for certain out of pocket expenses. A written guide that the custodian generally provided to the investment managers of Fund custody clients also referenced out-of-pocket expenses, describing them as "generally understood in the securities industry to mean costs for items paid by the custodian on behalf of the investor," which are "reimbursable to the custodian."

However, instead of billing custodial clients in amounts necessary to reimburse the custodian for its out-of-pocket costs, for over *15 years* the custodian charged over 5,000 Registered Funds millions more than its costs for certain expenses, most of which were charges for outbound SWIFT messages. But it wasn't just an oops. During this time span, the custodian recognized that it was charging a mark-up for these and certain other expenses. In fact, the bank decided to reduce the SWIFT-related charges, *but it did so only for new custodial clients or existing clients that had not yet incurred SWIFT charges*.

As a result of the over-charging, the records that the custodian was required to maintain for the Funds reflected inflated expenses, and further the over charges of course made their way into the funds' registration statements, periodic reports and financial statements, and in some cases impacted expense cap arrangements. In addition to finding that the custodian caused the Funds' violations of Section 31 and the rules thereunder, the SEC also found that the custodian *itself violated* 1940 Act Section 34(b).[3] The SEC ordered the custodian to, among other things, pay disgorgement and interest of just under $49M, and a civil money penalty of $40M.

The Private Fund Administrator That Followed the Adviser's Instructions (2020)[4]

The SEC returned to Fund administrators the following year, bringing an administrative proceeding against two affiliated Private Fund administrators, with echoes of the 2016 proceedings described above. For about a year and a half, the administrators provided administration services to a master fund and two feeder funds pursuant to a written contract. These administrators had succeeded another fund administrator (Prior Administrator), which calculated the Funds' NAV until the new administrators began to provide administration services. Pursuant to the administration agreements, the administrators agreed to, among other things, calculate monthly NAVs and prepare monthly financial statements for the Funds and to produce and distribute periodic reporting of account balances to Fund investors. The administrators also provided pricing and valuation verification services to the Funds pursuant to guidelines agreed to with the Funds' investment adviser. In a nutshell, the administrators followed various instructions from the investment adviser, which was misappropriating Fund assets, despite a number of "red flags."

- *Due Diligence and Onboarding Period*—During this period, the administrators conducted due diligence on the adviser, but they did not identify a civil action filed by an investor against the adviser, its principal and others, which included allegations that the investor had been defrauded.

  In addition, the administrators learned from the Prior Administrator that, among other things: the adviser had cash flow issues; the adviser had transferred money from the Funds to the adviser and accounted for those transfers as a promissory note and receivable (which was not repaid on time); payments purportedly related to the Funds' expenses had also been booked as a receivable due from the adviser; and one of the Funds' significant holdings was a private entity which was affiliated with the adviser. During this time, the administrators themselves also questioned whether the adviser possessed sufficient assets to meet its current liabilities.

  The administrators also became aware during the onboarding process that although the Funds' private placement memoranda stated that an independent firm had been retained to audit the Funds and that Fund investors would receive audited financial statements, no audits had taken place (even though the Funds had been in operation for about three years at this point).
- *While Serving as Administrator*—Mostly within the first few months after beginning to provide administrative services, the adviser misappropriated money from the Funds using letters of authorization that did not include support for the withdrawals. The administrators followed the adviser's instruction to add these outgoing funds to a large receivable that already existed as being due from the adviser, even though the adviser made it clear that there was no back up support for this. Per the SEC, this enabled the adviser to conceal the misappropriation of Fund assets.

  In addition, notwithstanding that the promissory note had not been repaid upon maturity and was instead extended by the adviser, the administrators accounted for the promissory note in the normal course rather than discounting the value or taking some other appropriate action.[5]

The administrators also followed the adviser's instruction not to deduct certain Fund operating expenses from the Funds' profits but rather, to book them as an offsetting reimbursement due from the adviser. The administrators did not question whether the adviser could actually repay the Funds, or whether it was legally obligated to do so. By booking an offsetting receivable, the Funds' NAV was artificially inflated.

The administrators followed yet another instruction from the adviser, without question, to increase the Funds' monthly income by the amount of a hypothetical performance gain or "true-up," which the adviser said reflected the estimated performance of previous Fund investments, and to book the gains as a receivable due from the adviser.[6] This also artificially inflated NAV.

Lastly, the administrators did not obtain support for the valuation of an adviser-priced Fund investment in a private company affiliated with the adviser, even though the valuation guidelines required the administrators to do so for any adviser-priced security. The administrators accepted the adviser's valuation of this holding without substantiation. Eventually, they wrote the value of this holding down to zero.

The SEC found that the administrators were a cause of the advisers' violations of Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder. The SEC ordered the administrators to, among other things, pay disgorgement and interest of approximately $17,500, and pay a civil money penalty of $150,000. Like certain of the proceedings from years past, the SEC expects Fund administrators to be gatekeepers and watchdogs, and following the adviser's instructions without question is not consistent with those roles, which is what happened with the next proceeding, about three years later.

Another Case of a Private Fund Administrator That Followed the Adviser's Instructions (2023)[7]

The administrator in this proceeding served as such for a Private Fund for only a little over a year. According to the SEC, the Fund's adviser misrepresented the Fund's performance in order to lull current investors into maintaining their Fund investments and to induce the investors into investing more; directed the creation of and approved an inflated NAV for the Fund; and provided false and misleading performance results to Fund investors in investor statements generated by the administrator (the statements represented positive returns and increasing account balances based on purported fund gains from trading, when in reality, the purported gains were false and the Fund had actually lost money). As a result, the adviser violated Section 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder, and Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (1933 Act).

The SEC found that the administrator was a cause of the adviser's violations concerning the false and misleading investor statements because it, among other things, accounted for certain Fund losses in a manner directed by the adviser, without evaluating whether this was appropriate and despite what the SEC characterized as red flags, which according to the SEC ultimately contributed to the adviser's violations. The SEC also observed that the administrator had "minimal" policies or procedures regarding onboarding new clients. And the problems began early on in the relationship.

First, the administration agreement required the adviser to provide the administrator with access to the Fund's monthly bank account statements, but the adviser never did that. In fact, the administrator knew that the Fund did not have its own bank account; instead, money invested in the Fund was sent to the adviser's bank account.

The administration agreement also required the adviser to appoint an independent auditor to conduct an audit of the Fund's financial statements. The administrator did not verify this during the onboarding process (even though at that point the Fund had been in operation since the prior year). About a year into the relationship, the administrator inquired about the audit and learned that the adviser had never engaged an auditor.

The administration agreement further required the adviser to instruct brokerage firms to provide the administrator with monthly account statements, transaction confirmations, and brokerage account access so that the administrator could, among other things, reconcile transactions, positions, and cash. However, the only trading information that the adviser provided to the administrator as part of the onboarding process was the adviser's trading account with another adviser (Firm A). The adviser served as a sub-adviser for Firm A with respect to an advisory client of Firm A, but the adviser traded Fund money in this account and the administrator knew about it. The statements, which the administrator reviewed as part of its onboarding process, showed significant losses over a three-month period, totaling over 75 percent of the Fund's assets. Over time, the adviser continued to lose money trading in this account.

This becomes relevant to the NAV calculation, which under the administration agreement the administrator was required to calculate.[8] NAV was included in the Fund investor statements that the administrator uploaded to the investor portal after the adviser's approval.[9] The administrator initially accounted for the losses in this trading account as losses of the Fund, but when it provided the investor statements to the adviser for review and approval, the adviser instructed the administrator to record an expense reimbursement for all losses as a receivable due from the adviser, which offset the effect of the loss, resulting in no reduction to NAV. The adviser further instructed the administrator to do this going forward.

The administrator agreed, without evaluating whether this was appropriate, determining the collectability of the receivable, or verifying that any legal repayment requirement existed.[10]

Further, at the adviser's request, the administrator created two Fund fact sheets, one that reflected the accounting treatment described above, and thus showed positive Fund performance, and one that reflected the trading account losses as Fund losses, and thus showed negative performance. The SEC gave an example of the performance difference—almost 150 percent positive performance versus 64 percent negative performance for the same time period. Yet the administrator still did not raise questions or ask for support of the treatment of the trading losses as a receivable.

About one year into the relationship, the adviser informed the administrator that it was closing the account associated with Firm A, at which time the receivable had grown to almost $1M. The receivable was not paid to the Fund. Given this, and after learning that the adviser had not engaged an auditor as required, the administrator suggested to the adviser that it make certain specific disclosures to Fund investors about the trading losses, the receivable and a payment plan. The adviser did not do that, and the administrator continued as usual.

About a month later, the administrator sent the adviser a termination letter stating it had elected to terminate the administration agreement based on the adviser's breach of conditions of the agreement, notably the adviser's failure to make the suggested disclosures to Fund investors. The termination letter stated that if the adviser failed to cure the breach, the administration agreement would terminate at the end of 30 days.

After the termination letter was delivered, however, the administrator continued as usual, with the same accounting treatment for the losses and the receivable, calculating NAV in the same way, sending investor statements that included the administrator's NAV. At no time before or after the termination letter was sent did the administrator revise its internal accounting in any way to reflect that the losses were actually Fund losses or add any additional disclaimers to the investor statements.[11]

The SEC found that the administrator was a cause of the adviser's violations of Section 206(4) of the Advisers Act and Rule 206(4)-8, as well as of Sections 17(a)(2) and 17(a)(3) of the 1933 Act. The SEC ordered the administrator to, among other things, pay disgorgement of about $22,000 and civil penalties of $100,000. The administration relationship here was relatively short—only about a year—yet this proceeding reflects a regulatory expectation that Fund administrators not only serve as gatekeepers/watchdogs, but also that they act, and act quickly, as delays in asking questions pose risk, even if followed by the administration's termination of the relationship.

Conclusion

As these proceedings demonstrate, over the years, the SEC does not hesitate in bringing enforcement actions against third-party Fund service providers. They also demonstrate that regulatory expectations, particularly of Fund administrators, have expanded over time, from perhaps a more obvious consequence of being a co-conspirator of sorts in a 2006 marketing budget proceeding, to, in more recent proceedings, being responsible for detecting and preventing misappropriation and fraud at the hands of the Fund fiduciary that hired them (in the context of Private Fund administrators) or recommended the same to the Fund's governing body (in the context of Registered Funds).[12]

A 2022 administrative proceeding against a Private Fund adviser describes the conduct of a Fund administrator, which apparently insulated it from being implicated.[13] In relevant part, the adviser engaged in trading that was inconsistent with the Fund's offering memorandum. The trading resulted in the loss of nearly all of the Fund's assets. The adviser wanted to hide the losses, so the adviser's principal asked the administrator to characterize money that the principal had recently added to the Fund as limited partner capital contributions rather than as trading losses. The administrator refused, and promptly terminated its relationship with the adviser and the Fund.

A 2023 administrative proceeding, however, sets out facts that appear to place the service provider squarely at the root of the problem, but the service provider was not named.[14] A registered broker-dealer (which was dually registered as an investment adviser) undertook a project to delete from its computer systems older communications and documents that were no longer required to be retained. However, the firm deleted certain electronic communications, based on an understanding that the communications that were still within required retention period would not be permanently deleted from the system. This understanding was based on written representations from the firm's archiving vendor.[15] However, the vendor had not properly applied the retention setting and thus the firm had permanently deleted communications that were still required to be maintained. The firm, which was under multiple regulatory investigations, reported this to the SEC and had to pay a $4M civil money penalty.[16]

SEC enforcement action decisions are of course influenced by myriad facts, factors and circumstances regarding the potential respondents and otherwise, which may or may not be reflected squarely within the four corners of the related release. These decisions, for better or for worse, are also influenced by historical, recent and current market, national and international events and circumstances of various types, and by the current views of the SEC and its personnel. In regard to the latter, future regulatory developments certainly could change the relative regulatory risk for third-party Fund service providers. For example, in 2022 the SEC proposed the adoption of a new Advisers Act rule regarding outsourcing by registered investment advisers.[17] In the proposing release, the SEC asked interesting questions about this topic, including questions about whether any such rule, if adopted, should apply to Registered Fund service providers.[18] It is possible that this rule, if adopted in its final form, could modify the regulator's views regarding the allocation of comparative regulatory liability among third-party Fund service providers, investment advisers and other relevant parties in a manner that would be helpful to such service providers. But more likely is an increase in regulatory liability for registered investment advisers, rather than a decrease in the same for third-party Fund service providers, for better or for worse.

Ms. Cruz is counsel in the Washington, DC office of Mayer Brown, LLP. She has been an investment management practitioner since 1995, and serves on *The Investment Lawyer's* Editorial Board. She thanks her colleague Adam Kanter for reading and making valuable contributions to this article. She also thanks her colleague Blair Christian for conducting the research for this article. The views expressed are those of Ms. Cruz and do not necessarily reflect the views of the firm, its other lawyers, or its clients.

NOTES

1 Advisers Act Release No. 4847 (Jan. 22, 2018). In the release, the SEC noted that this Fund administrator and an affiliate were the subjects of a prior SEC enforcement proceeding against "mutual fund 'gatekeepers' for causing untrue or misleading disclosures", which is the 2013 proceeding summarized in Part 1 of this article (see therein Note 5 and related text).

2 1940 Act Release No. 33534 (June 27, 2019).

3 The SEC made the same finding in the 2016 proceeding against this custodian bank.

4 Advisers Act Release No. 5585 (Sept. 18, 2020).

5 In addition, the administrator included the promissory note and interest in its calculations of investors' capital account balances and returns for four months, even though the administrators knew at the time that the promissory note had matured but had not been repaid or extended.

6 The adviser told the administrators that these Fund holdings had been liquidated during the conversion to the administrators' platform and had not been reinvested, and further that the adviser apparently wanted to "reimburse" Fund investors for any gains they would have received had the investments been retained.

7 Advisers Act Release No. 6367 (Aug. 7, 2023).

8 The SEC observed that the administrator had "minimal" NAV accounting policies or procedures.

9 The SEC observed that the investor statements provided in bold font that the administrator was an "Independent Fund Administrator" and lacked any disclaimers other than a statement that the amounts were unaudited and not to be used for income tax purposes.

10 In this regard, the administrator simply accepted the adviser's word that the adviser was legally liable to reimburse the losses (which was untrue).

11 *See supra* n.9.

12 Unlike third-party Fund service providers, which act on behalf of the Fund or the Fund adviser/as an agent (that is, they sit on the "same side of the table" as the Fund or its adviser and under contract are obligated to provide certain services to or on behalf of the Fund or the adviser), the regulatory risk of mere third-party Fund counterparties for the Fund's or the Fund adviser's violations of applicable federal securities laws, is comparatively small. These parties usually act on their own behalf/as a principal (that is, they sit on the opposite side of the table from the Fund or its adviser), and under any contract with the Fund or the adviser, generally do not obligate themselves to, for example, maintain 1940 Act or Advisers Act records on behalf of the Fund or the adviser. *See*, for example, Investment Advisers Act Release No. 3762 (Jan. 27, 2014) and Investment Company Act Release No. 31455 (Feb. 12, 2015). However, this does not mean that Fund counterparties are simply free from enforcement risk, particularly, for example, where the relevant contract indicates otherwise, or

the counterparty egregiously turns a blind eye to fraud.

13 Advisers Act Release No. 6090 (Aug. 16, 2022). Similar to prior administrative proceedings, the SEC specifically described the responsibilities that the administrator undertook for the adviser with respect to the Fund.

14 Securities Exchange Act Release No. 97787 (June 22, 2023).

15 In fact, the vendor periodically represented to the firm, and separately to FINRA, that its media storage complied with Rule 17a-4(b) under the Securities Exchange Act of 1934, including that a default retention period of thirty-six months was applied to all electronic communications – and thus that documents within the retention window could not be permanently deleted.

16 In contrast, in 2021, the SEC brought an enforcement action against an index provider, which licensed a particular index to various parties that used the index to establish, structure, manage, offer, and sell securities, one of which was an exchange-traded note that was linked to this index (pursuant to a license agreement with the index provider). The facts are complicated, but suffice it to say that the index had an undisclosed feature that caused it to remain static during certain time periods even though there was notable market volatility during those periods and even though the index was supposed to calculate values based on real-time prices. The SEC found that the index provider violated Section 17(a)(3) of the Securities Act, and ordered the provider to, among other things, pay a $9M civil money penalty. The issuer of the note, which was not named, even though it sold the note based, in part, on index data. Securities Act Release No. 10943 (May 17, 2021).

17 Advisers Act Release No. 6176 (Oct. 26, 2022). The views of the SEC and its Staff regarding cybersecurity responsibilities of market participants also have focused on the participants' responsibilities in that regard, including oversight of cybersecurity consultants and other service providers, as highlighted in various SEC Enforcement Division Risk Alerts over the years (for example, *https://www.sec.gov/files/Risk%20Alert%20-%20Credential%20Compromise.pdf*; *https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf*). *See also*, Advisers Act Release No. 6138 (Sept. 20, 2022) (adviser's oversight of a third-party vendor that did not properly safeguard customers' personal identifying information). But see *https://www.wsj.com/articles/fund-administrator-for-fortress-pimco-and-others-suffers-data-breach-through-vendor-11595857765*.

18 *See also* Advisers Act Release No. 4429 (June 16, 2016).