Published on *The National Law Review* https://natlawreview.com

U.S. Securities & Exchange Commision (SEC) Brings Charges Against SEC Registered Investment Adviser for Improperly Allocating Expenses and Other Violations of the Investment Advisers Act of 1940

Article By:

Thomas M. Devaney

Jung Yeon Son

On February 25, 2014 the Securities and Exchange Commission (the "SEC") filed public administrative and cease-and-desist proceedings against Arizona-based **Clean Energy Capital, LLC** (a registered investment adviser, "CEC") and its founder and Chief Executive Officer Scott Brittenham charging that CEC and Brittenham committed the following violations with respect to the 20 private equity funds sold and managed by CEC primarily under the name of Ethanol Capital Partnership, L.P. (the "ECP Funds")…

1. CEC and Brittenham misappropriated more than $3 million from the ECP Funds by improperly allocating CEC's expenses to the ECP Funds without adequate disclosure to investors.

2. CEC and Brittenham secretly caused the ECP Funds to borrow money from CEC at unfavorable rates, pledging the ECP Funds' own assets as collateral, to enable the ECP Funds to pay for these inappropriate expenses.

3. Beginning in August 2011, CEC changed the calculation of dividend distributions for certain of the ECP Funds, which adversely affected the dividends received by certain of their investors and increased distributions to CEC, without disclosure to investors.

4. In 2009, CEC and Brittenham falsely induced a previous investor to invest in a new ECP Fund by knowingly misrepresenting the amounts of the investments by Brittenham and another co-founder in the new ECP Fund.

5. CEC violated the custody rule by failing to use a qualified custodian and failing to segregate fund assets.

6. CEC's compliance policy was inadequate because it incorrectly described the custody rule, which resulted in the above violation.

7. For the ECP Funds offered in late 2008-2010, CEC concealed a co-founder's SEC disciplinary history in the offering documents for the funds.

Improper Allocations

As described in the SEC's order, CEC and Brittenham improperly allocated at least $3 million of expenses, primarily for CEC employee compensation and CEC office expenses, to 19 of the ECP Funds. These expenses included CEC's rent, salaries, office lunches, business cards, employee hiring costs, gifts, CEC registration expenses and other employee benefits such as tuition costs, retirement, and bonuses. Brittenham allocated approximately $1.1 million to himself, including 70% of a $100,000 bonus he awarded to himself.

Improper Loans

The payment of the improperly allocated expenses shrank the cash reserve of the ECP Funds. In order to continue paying for such expenses with ECP Fund assets, CEC made unauthorized "loans" to the funds with inflated interest rates reaching as high as 17.38%. CEC also entered into pledge agreements with these ECP Funds, giving CEC a first priority security interest in the respective ECP Funds' assets. The pledge agreements constituted principal transactions between CEC and the ECP Funds, and neither CEC nor Brittenham provided written notice or obtained consent from the ECP Funds prior to such principal transactions.

Improper Distributions

CEC and Brittenham further benefitted when they changed the way that CEC calculated the distribution waterfall in several respects to the detriment of fund investors and with inadequate or no disclosure of these material changes to the investors.

Misrepresentations

Brittenham also lied to an investor of the ECP Funds and told him that he and another co-founder were personally investing $100,000 each in the fund in order to induce the investor to contribute to the ECP Funds. In reality, Brittenham and the co-founder only invested $25,000 each in the ECP Funds.

Violation of Custody Rule and Inadequate Compliance Policies and Improper Disclosure

Rather than utilize a qualified custodian, CEC kept original stock certificates for securities owned by the ECP Funds in its office. CEC also did not send audited financial statements to the limited partners of the ECP Funds until January 2013, at which time it sent audited financial statements for fiscal year 2011. No audited financial statements have been sent since January 2013. CEC also never obtained a surprise exam.

In addition, some of CEC's compliance policies incorrectly described the custody rule, Rule 206(4)-2(b) under the Investment Advisers Act of 1940. Finally, the private placement memoranda for certain offerings of the ECP Funds, which were offered and sold to investors from December 2008 through June 2010, did not disclose a co-founder's previous disciplinary settlement with the SEC.

Violations of Law

The SEC charges that as a result of the conduct described above, CEC and Brittenham willfully violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities.

In addition, CEC and Brittenham willfully violated the Advisers Act and Rule 206(4)-8(a) promulgated thereunder, which, among other things, prohibit fraudulent conduct. The SEC also alleges that CEC and Brittenham willfully violated the prohibition against principal transactions without proper disclosure and consent, willfully retained custody of clients' funds and securities without retaining a qualified custodian, willfully violated the requirement to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules and willfully violated Section 207 of the Advisers Act which makes it unlawful to make any untrue statement of a material fact in any registration report filed with the SEC.

In light of these allegations, the SEC has ordered cease-and-desist proceedings to determine whether the allegations are true and what remedial action is appropriate, including, but not limited to, disgorgement and civil penalties.

Next Steps

CEC and Brittenham have twenty days to respond to the SEC order and a public hearing will be held between 30 and 60 days from the service of the order. An administrative law judge will issue an initial decision within 300 days of the date of service of the order.

Commentary

Of particular note to CCOs, we observe that even though the SEC proverbially "threw the book" at CEC and charged CEC and its founder with a number of "minor" violations such as improperly describing the custody rule in CEC's compliance policies in connection with the more serious fraud charges, the SEC interestingly did not charge CEC's CCO with any wrongdoing. The SEC action describes the facts surrounding the CCO's actions while CEC's founder was lying to an investor regarding the amount of investment that the founder was making in a newly-launched fund advised by CEC. The facts state that (i) the CCO accused the founder over email of asking him to lie to the investor about the amount of the founder's investment in the new ECP fund and (ii) the CCO refused to lie to the investor and resigned over the matter. We believe that this particular fact pattern shows that a CCO may be able to protect herself from SEC action if she knows that there are occurrences of violations of law at the investment adviser with whom she is associated if she promptly documents the violation and resigns if the violation is not remedied to her satisfaction.

National Law Review, Volume IV, Number 84