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SEC Targeting Investment Adviser Fraud

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On February 2, 2017, the SEC charged an investment advisory business and its owner, Mark Varacchi, with stealing at least $3.9 million from investors. According to the SEC's complaint, Varacchi misrepresented to investors that money would be allocated to up-and-coming hedge fund managers for investment purposes. But Varacchi instead commingled investor assets and manipulated account activity to steal nearly $4 million from his clients, including more than $1 million to settle litigations brought by Varacchi's previous employer.

Unscrupulous investment advisors should expect to see similar enforcement actions in the future. In a recent speech, the director of the SEC Office of Compliance Inspections and Examinations revealed that the agency has increased staffing in the Investment Adviser/Investment Company ("IA/AC") Examination Program by 20%. This expansion confirms the SEC's continued focus on investigations and enforcement actions related to investment adviser fraud, such as:

- misleading fee agreements;
- failing to disclosure conflicts of interest;
- improper allocation of expenses;
- false advertising of performance; and
- "parking" schemes.

In his speech, the director explained that investment advisers are one of the fastest-growing groups of SEC registrants. In the past two years, over 2,000 new advisers have registered, bringing the total number of registered investment advisers to more than 12,000. And unlike broker-dealers, a vast majority of these investment advisers are regulated only by the SEC. As such, the SEC has chosen to be more reliant on FINRA—the self-regulatory organization that shares oversight of the broker-dealer industry with the SEC—and allocate more of its resources to combatting IA/AC fraud.

The increase in both registered investment advisors and the SEC's staff represents an opportunity for individuals with knowledge of IA/AC violations to blow the whistle and become eligible for an SEC award.

SEC Whistleblower Program

Under the SEC Whistleblower Program, whistleblowers may be eligible for monetary awards when they voluntarily provide the SEC with original information about violations of federal securities laws that leads to a successful enforcement action resulting in monetary sanctions exceeding $1,000,000. Whistleblowers are eligible to receive between 10% and 30% of the monetary sanctions collected.

The SEC Whistleblower Program also protects the confidentiality of whistleblowers and does not disclose information that might directly or indirectly reveal a whistleblower's identity. In fact, whistleblowers can even submit a tip anonymously if represented by counsel.

Since the law went into effect, the SEC Whistleblower Office has awarded more than $149 million to 41 whistleblowers. The largest award to date is more than $30 million. In 2016, the office issued more than $57 million in awards to whistleblowers.

SEC Investment Advisor Enforcement Actions

Due to the increase in IA/AC staff, we expect to see an increase in SEC enforcement actions against investment advisors in the coming years. Notably, even prior to the reallocation of resources, the SEC aggressively pursued enforcement actions against investment advisers. Recent SEC enforcement actions (see below) suggest the agency focuses on five areas of investment advisor fraud:

Failure to Properly Disclose Fee Arrangements

- In October 2015, three private equity advisers within The Blackstone Group agreed to pay nearly $39 million to settle charges that they failed to fully inform investors about benefits that they obtained from accelerated monitoring fees and discounts on legal fees.

- In August 2016, four private equity fund advisers affiliated with Apollo Global Management agreed to a $52.7 million settlement for, among other things, misleading fund investors about fees. Similar to The Blackstone Group's violation, Apollo and its advisers did not inform its investors about the benefits they received (to the detriment of fund investors) by accelerating the payment of future monitoring fees owed by the funds' portfolio companies upon the sale or IPO of those companies.

Failure to Disclose Conflicts of Interest

- In November 2015, a New York-based private equity firm, Fenway Partners LLC, and its 4 executives agreed to a $10.2 million settlement for failing to tell their fund clients that they rerouted portfolio company fees to an affiliate and avoided providing the benefits of those fees to the fund clients in the form of management fee offsets. In total, the private equity firm rerouted more than $20 million in payments out of fund assets or portfolio companies to the affiliated entity.

- In March 2016, three AIG affiliates agreed to pay more than $9.5 million to settle charges for steering fund clients toward more expensive share classes so that the firms could collect more fees. An SEC investigation revealed that the firms generated about $2 million in extra fees by placing clients in share classes that charged fees for marketing and distribution, despite the clients' being eligible to buy shares in fund classes without those additional charges.

Improper Allocation of Expenses

- In September 2016, private equity firm First Reserve Management L.P. negotiated a legal fee discount for work performed on its fund. Despite receiving the discount, First Reserve did not allocate any of it to the funds. First Reserve also failed to adequately inform its fund clients about, among other things, a liability insurance policy that covered First Reserve for risks not entirely arising from management of the funds (where the governing documents provided that the funds would pay only insurance expenses relating to the affairs of the funds). As a result of these violations, First Reserve was required to pay a civil penalty of $3.5 million.

- In November 2015, Cherokee Investment Partners LLC and Cherokee Advisers LLC incurred consulting, legal, and compliance-related expenses in the course of registering as an investment adviser. The company allocated $455,698 of these expenses to the fund, even though there was no disclosure that the funds would be charged for the advisers' legal and compliance expenses. The company was required to pay a civil monetary penalty of $100,000.

False Advertising of Performance

- In August 2016, the SEC announced penalties (ranging from $100,000 to a half-million dollars) against 13 investment advisory firms for accepting and negligently relying on claims by an investment marketing firm called F-Squared. Without obtaining sufficient documentation, the advisory firms recommended F-Squared's investment strategy to their own clients. An SEC enforcement action later revealed that the strategy—which was purportedly based on F-Squared's real, historical track record—was only back-tested performance that turned out to be substantially inflated. F-Squared was charged $35 million for its part in defrauding investors through false performance advertising.

"Parking" Schemes

- In December 2015, Morgan Stanley Investment Management agreed to pay $8.8 million to settle charges that one of its portfolio managers unlawfully conducted prearranged trading, known as "parking," that favored certain advisory clients over others. In the scheme, the Morgan Stanley adviser arranged sales of securities to another trader at a predetermined price that would enable the adviser to buy back the positions at a small markup into other accounts advised by Morgan Stanley.

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