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CLIENT ALERT

SEC Charges Private Equity Fund Adviser For Breach of Duties in Connection with GP-Led Secondary Transaction

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On September 22, 2023, the Securities and Exchange Commission ("**SEC**") announced a settled enforcement action against a SEC-registered investment adviser ("**the Adviser**") finding that the Adviser breached its fiduciary duties (the "**Order**").[1] The transaction at issue involved the transfer of a private fund investment from Adviser-sponsored and managed funds nearing the end of their terms to a new fund sponsored and managed by the same Adviser. The Order, among other considerations, highlights the SEC's continued interest in GP-led secondary transactions and the potential conflicts of interest inherent in such transactions. It also represents one of the first actions undertaken by the SEC with respect to GP-led secondary transactions.[2]

[1] *See In the Matter of American Infrastructure Funds, LLC*, Investment Advisers Act Release No. 6428 (Sept. 22, 2023), available here.

[2] *See* FY 2023 Examinations Priorities, Securities and Exchange Commission, Division of Examinations (Feb. 7, 2023), at 11 (identifying "private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds" as an examination focus), available here. For a discussion of the Division's 2023 priorities, please see our memo, SEC Division of Examinations Releases Its 2023 Examination Priorities, available here.

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Background

American Infrastructure Funds, LLC advises private funds that make investments in infrastructure and real property-based assets and businesses. As of March 2023, the Adviser had approximately $1.3 billion in assets under management. From 2012 through the end of 2015, certain funds advised by the Adviser (the "**Original Funds**") invested approximately $70 million in a portfolio company. In June 2016, close to the expiration of the initial ten-year term of the Original Funds, the Adviser transferred the portfolio company assets to a newly formed private fund created and managed by the Adviser (the "**New Fund**") that had a longer term. In exchange for the transfer, the Original Funds each became an investor in and received a limited partner interest in the New Fund (which effectively functioned as an extension of the Original Funds' term, locking up the Original Funds' investors beyond the initial term of the Original Funds), and entitled the Original Funds to receive the majority of the carried interest in, and any management fees earned from, the New Fund. Although the Adviser notified the Original Funds' LP Advisory Committee ("**LPAC**") and limited partners about its plan to raise additional capital through the New Fund, the Adviser failed to disclose to investors the additional term of the investment, the fact that investors had no opportunity to object or exit, and the fact that the Adviser was acting as an adviser to both the Original Funds and the New Fund as a result of the transfer. The SEC's order found that the Adviser's failure to disclose these conflicts before transferring the portfolio company assets to the New Fund breached the Adviser's fiduciary duty to the Original Funds.

Violations, Sanctions, and Remediation

The Order found that the Adviser's conduct violated Section 206(2) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which makes it unlawful for an investment adviser to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client, and Section 206(4) of the Advisers Act and Rules 206(4)-8 and 206(4)-7 thereunder, which make it unlawful for an investment adviser to a pooled investment vehicle to engage in any act, practice or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor, and to fail to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules, respectively. The SEC imposed a cease-and-desist order and a censure and ordered the Adviser to pay disgorgement, prejudgment interest and a civil monetary penalty of $1,645,460. The Order also required the Adviser to notify past and current investors in the Original Funds of the settlement terms.

Key Observations

This enforcement action represents the SEC's latest effort in enhancing private fund investor protections, generally, and in scrutinizing GP-led secondary transactions, in particular. The SEC and its staff have highlighted GP-led secondaries on a number of occasions in recent years, including in the 2023 Priorities issued by the staff of the Division of Examinations and in the new rules and amendments under the Advisers Act that will prohibit certain practices of private fund advisers (the

"**Private Fund Adviser Rule**" or the "**Final Rules**").[3] In the release accompanying the Private Fund Adviser Rules, the SEC noted the inherent conflicts such transactions present where the sponsor is on both the buy side and sell side of a transaction that involves the sale of one or more underlying fund investments from one sponsor-advised client to a continuation vehicle managed by the same sponsor.[4] Because a sponsor has the opportunity to earn management fees, carried interest and potentially other noneconomic benefits from the GP-led secondary transaction (such as stapled commitments to other sponsor-advised products, like the New Fund), the SEC is particularly focused on mitigating the potential conflicts arising out of these types of transactions.

The Order is the latest reminder that GP-led secondary transactions will remain an exam and enforcement priority for the SEC. Sponsors should remember that merely notifying the LPAC or investors of a potential GP-led transaction is not sufficient in the eyes of the SEC. The quality of disclosures around the conflicts these transactions present and the specific terms of these transactions (including any status quo or alternative liquidity options) remain key issues.

[3] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 6383 (Aug. 23, 2023) (the "**Adopting Release**"), available here. On September 1, 2023, six private equity and hedge fund trade groups filed suit against the SEC in the Fifth U.S. Circuit Court of Appeals seeking to vacate the Final Rules. This client alert expresses no opinion on the merits or likely outcome of such proceeding and assumes the Final Rules will become effective on the compliance dates noted by the SEC in the Final Rules.

[4] *See* Adopting Release, at 190. Our client alerts discussing the Final Rules, and their impact on GP-led secondary transactions, are available here and here. The SEC defines a GP-led secondary transaction as any transaction initiated by the adviser or any of its related persons that offers the private fund's investors the choice between: (i) selling all or a portion of their interests in the private fund and (ii) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

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