Davis Polk

Private Equity Regulatory Update – June 2021

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Here is our latest report on regulatory developments relating to private equity and investment management. In this issue, we discuss, among other things, recent SEC enforcement actions involving funds and investment advisers, and relevant industry and SEC updates.

Rules and regulations

SEC approves inflation adjustment of dollar amount tests for qualified clients under Advisers Act rule 205-3

On June 17, 2021, the U.S. Securities and Exchange Commission (the SEC) published an order approving its previously proposed inflation-related adjustments to the dollar amount thresholds in Rule 205-3 under the U.S. Investment Advisers Act of 1940 (the Advisers Act). The SEC's order, which is slated to become effective on August 16, 2021, will increase the dollar amount of the assets under management test from $1,000,000 to $1,100,000 and the dollar amount of the net worth test from $2,100,000 to $2,200,000, to reflect inflation from 2016 to the end of 2020.

As background, Rule 205-3 of the Advisers Act permits registered investment advisers to charge performance-based fees to "qualified clients." Qualified clients include, in addition to clients qualifying under a dollar amount test, clients the adviser reasonably believes are "qualified purchasers" as defined under section 2(a)(51)(A) of the Investment Company Act of 1940, as amended (the Investment Company Act), and directors and certain officers and knowledgeable

employees of the adviser. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to adjust the financial criteria set forth in Rule 205-3 to reflect inflation (rounded to the nearest $100,000) every five years, with the prior inflation adjustment taking place in 2016.

According to the SEC order, the adjusted dollar test amounts generally do not apply retroactively to the extent contractual relationships are entered into prior to the order's effective date, subject to the transition requirements in Rule 206-5.

– See a copy of the SEC order

Litigation

SEC sues mutual fund adviser, principals, and settles with chief risk officer for alleged misrepresentations concealing risk of "worst-case" loss

On May 27, 2021, the SEC filed a complaint (the LJM Complaint) in the U.S. District Court for the Northern District of Illinois against Anthony Caine (Caine), Amish Parvataneni (Parvataneni), LJM Funds Management, Ltd., and LJM Partners, Ltd. (together, LJM). LJM served as the investment adviser to three funds that allegedly suffered more than $1 billion in losses in February 2018. Caine was LJM's founder, owner, chairman, and co-portfolio manager; Parvataneni was LJM's co-portfolio manager. The same day, the SEC issued an order (the Ariathurai Order) instituting and settling cease-and-desist proceedings against Arjuna Ariathurai (Ariathurai), Chief Risk Officer of LJM. According to the SEC, LJM materially misrepresented its risk management strategies and the risks of significant losses in "worst-case" scenarios.

LJM managed a mutual fund and several private funds. According to the SEC, LJM's investment strategy involved writing short-dated, out-of-the-money options on S&P 500 futures contracts. The SEC characterized this strategy as offering the potential of relatively stable profits, but carrying the risk of significant losses during large market swings. The SEC complaint alleges that LJM was aware of these risks, and generated a daily "stress test" report that tested the funds' portfolios against certain historical scenarios, including 1987's "Black Monday," September 11, 2001, the "2008 Credit Crisis," and the 2010 "Flash Crash." These scenarios allegedly showed that, over the 18 months preceding June 1, 2016, the average losses in many scenarios exceeded 50%, and in some instances exceeded 100% of the portfolio value.

The SEC alleges that LJM recognized that these scenarios were "ugly," and that Caine directed Ariathurai to work with Parvataneni to develop a "tool for sales staff to respond to [risk] questions" in a more positive light. LJM thus allegedly developed a narrative informing investors that it expected "worst-case" losses ranging from 20% to 40%.

In late 2017 and early 2018, the SEC alleges that LJM increased risk to earn increased returns, and that LJM, Caine, and Parvataneni were made aware of these risks through internal reports. These reports allegedly showed that risk of significant losses had increased, and, in early 2018, Caine, Parvataneni, and Ariathurai held a meeting discussing the potential losses that could result from the elevated risk levels. Cain allegedly rejected a suggestion to reduce risk levels at that time.

In February 2018, the funds LJM managed suffered losses of over $1 billion, about 80% of their value. These losses resulted in the funds' liquidation. Caine allegedly took dividends from LJM exceeding $5 million after the funds suffered the losses in February 2018.

The SEC alleges that LJM, Caine, and Parvataneni each committed violations of the Securities Exchange Act of 1934 (Exchange Act), Securities Act of 1933 (Securities Act), Advisers Act, and Investment Company Act. The SEC also alleged that Ariathurai violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, and that Ariathurai aided, abetted, and caused LJM's violations of the Advisers Act and the Investment Company Act. Ariathurai agreed to cease and desist from further violations, to be barred from the securities industry, subject to a right to reapply after three years, and to pay disgorgement of $83,333, interest of $14,111, and a civil penalty of $150,000.

– See a copy of the LJM Complaint
– See a copy of the Ariathurai Order
– See a copy of the SEC press release regarding the LJM Complaint and Ariathurai Order

SEC settles undisclosed conflict of interest allegations against adviser, principal and CFO

On June 4, 2021, the SEC issued two orders instituting and settling cease-and-desist proceedings against VII Peaks Capital, LLC (VII Peaks), a registered investment adviser, Gurprit Chandhoke (Chandhoke), its co-principal, managing member, and Chief Investment Officer, and Michelle MacDonald (MacDonald), the Chief Financial Officer and, since May 2019, Chief Compliance Officer of VII Peaks.

The SEC orders state that VII Peaks served as investment adviser to VII Peaks Co-Optivist Income BDC II, Inc. (BDC), a business development company. During the relevant period the BDC made secured loans to companies. Chandhoke allegedly made all investment decisions on behalf of BDC from 2015 through 2018, in exchange for which VII Peaks received a management fee of 2% of the net asset value of BDC and, under certain circumstances a 20% performance fee.

The SEC alleges that from 2015 through 2017, BDC received due diligence fees when making loans, which BDC transferred to VII Peaks. VII Peaks allegedly failed to disclose to BDC's Board of Directors that these fees were retained by VII Peaks rather than paid to third-parties engaged to perform due diligence. VII Peaks allegedly received $722,500 in due diligence fees during the relevant period; Chandhoke received $87,500 of this amount.

The SEC further alleged that Chandhoke entered into two transactions that benefited himself and that created actual or potential conflicts of interest between him and BDC. First, Chandhoke allegedly failed to inform BDC's Board of Directors that he was affiliated with a software engineering services company engaged by a portfolio company. Second, he allegedly received a personal loan from a company owned and controlled by the CEO of a portfolio company.

With respect to MacDonald, in her capacity as CFO, the SEC alleges that MacDonald "failed to exercise reasonable care" by causing BDC to pay diligence fees to VII Peaks and failing to disclose to the Board of Directors that VII Peaks would retain those fees.

On account of this conduct, VII Peaks, Chandhoke, and MacDonald allegedly violated Section 206(2) of the Advisers Act, Chandhoke allegedly violated Section 57(a) of the Investment Company Act, and VII Peaks allegedly violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

VII Peaks, Chandhoke, and MacDonald each agreed to cease and desist from further violations. Chandhoke agreed to a 12-month suspension; VII Peaks agreed to be censured. VII Peaks also agreed to pay disgorgement of $722,500, prejudgment interest of $123,199, and a civil money penalty of $185,000; Chandhoke agreed to pay disgorgement of $87,500 and prejudgment interest of $16,857, plus a civil money penalty of $90,000. MacDonald agreed to pay a civil money penalty of $20,000.

– See a copy of the VII Peaks / Chandhoke Order
– See a copy of the MacDonald Order