

Investment Management & Funds Regulatory Update - November 2023

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In this issue, we discuss recent enforcement actions and litigation involving investment advisers.

Litigation

SEC sues, and U.S. Attorney's Office charges, principal and CCO of investment adviser for alleged multiyear fraud.

On November 2, 2023, the SEC filed a [civil complaint](#) (the Complaint) against John Hughes (Hughes), president and chief compliance officer of registered investment adviser, Prophecy Asset Management LP ("PAM") for allegedly misleading "the funds' investors, auditors, and administrator about the funds' trading practices, risk, and performance – all while collecting more than \$15 million in fees." The suit is captioned *SEC v. Hughes*, 3:23-CV-21816, and is pending in the U.S. District Court for the District of New Jersey. The U.S. Attorney's Office for the District of New Jersey also announced criminal charges against Hughes in a parallel action.

According to the Complaint from 2014 to March 2020, Hughes and others misled the investment funds' investors, prospective investors, auditors, and administrator about nearly every material aspect of the funds' management practices.

PAM served as the adviser to Prophecy Trading Advisors Master Fund LP (the Master Fund) and Prophecy Trading Advisors LP (PTA), both "purported hedge fund[s]." Hughes allegedly represented to investors that Prophecy followed a "first loss" business model, pursuant to which sub-advisers received management fees and a percentage of trading profits, but also were responsible for covering losses up to an agreed amount and required to post 10% of the trading allocation as cash collateral. Hughes also allegedly represented that the funds' sub-adviser diversification minimized concentration risk, and that Prophecy generated a steady stream of "mid to high single-digit annual returns uncorrelated to market conditions or the performance of the sub-advisers."

The Complaint alleges that these representations were false. For example, Hughes allegedly misrepresented the funds' diversification by concealing the funds' concentrated allocation to one individual, which was presented as multiple independent sub-advisers, and allowed that individual to continue trading for the funds despite having incurred trading losses of as much as \$328 million in excess of the cash collateral posted. According to the Complaint, on a number of occasions Hughes concealed losses by causing the funds to enter into sham transactions or falsifying financial documents to show inflated amounts of cash collateral.

In a separate action, Hughes plead guilty to one count of conspiracy to commit securities fraud, noting that he "conspir[ed] to defraud dozens of victim investors out of \$294 million in funds." Hughes faces a maximum penalty of five years in prison and a \$250,000 fine. Hughes's sentencing hearing is scheduled for March 21, 2024.

On account of the conduct alleged, the SEC asserts that Hughes violated "antifraud provisions of the federal securities laws and seeks a permanent injunction, disgorgement of ill-gotten gains plus interest, civil penalties, and an officer and director bar." The SEC contends that Hughes, both directly and indirectly, violated Section 17(a) of the Securities Act of

1933; Section 10(b) of the Securities Exchange Act of 1934; Rule 10(b)-5 thereunder; Sections 206(1), (2), and (4) of the Investment Advisers Act of 1940; and Rule 206(4)-8 thereunder.

SEC settles with investment adviser for alleged failures to describe nature of investment.

In our [January 2023 update](#), we reported on a settlement between the SEC and a former portfolio manager of a registered investment fund relating to allegedly undisclosed conflicts of interest arising out of the fact that a child of the Portfolio Manager had a role in a film distributed by a company in which the Portfolio Manager had recommended an investment.

On October 24, 2023, the SEC issued an [order](#) (the Order) instituting and settling administrative and cease-and-desist proceedings with the large registered investment adviser (Adviser) relating to this prior settlement. According to the Order, Adviser's periodic reports relating to the relevant fund inaccurately described the film distribution and advertising company in which the fund had invested as being engaged in "Diversified Financial Services," based on information provided by a third-party vendor which Adviser failed to correct. The periodic reports also misstated the financial terms of the fund's investments in the entity.

In 2019, the Order states, Adviser discovered and corrected these errors during an investigation into potential misconduct by the entity's CEO. Adviser also voluntarily covered certain losses associated with the investment.

On account of this conduct, the SEC alleges that Adviser violated Section 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder, and Section 34(b) of the Investment Company Act. Adviser agreed to pay a civil money penalty of \$2.5 million, to be censured, and to cease and desist from further violations.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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