

Investment Management & Funds Regulatory Update - December 2023

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In this issue, we discuss a recent enforcement action involving an investment adviser and alleged custody rule violations.

Litigation

SEC settles with adviser regarding alleged custody rule violations

On December 1, 2023, the SEC issued an [order](#) (the Eagan Order) instituting and settling administrative and cease-and-desist proceedings against Eagan Capital Management, LLC (ECM), a registered investment adviser. The SEC alleges that Eagan violated Rule 206(4)-2 under the Advisers Act (the custody rule) with respect to two private real estate operating company funds that it advised, Rochester 153, LLC and Verity Investments, LLC (the Funds), and in which ECM's advisory clients invested.

The Eagan Order noted that under the custody rule, an investment adviser generally has custody of client assets if it directly or indirectly holds client funds or securities, or if it has the authority to obtain possession of such assets, or if a "related person" holds or has the authority to obtain possession of those assets in connection with advisory services the investment adviser provides to clients. The Eagan Order also noted that the custody rule generally requires that an investment adviser with custody, among other things, ensure that client funds and securities are verified by actual examination each year by an independent public accountant without prior notice (surprise examination) or, alternatively in the case of a fund, ensure that the fund is subject to an audit at least annually and distributes audited financial statements prepared in accordance with GAAP within 120 days of the end of the fund's fiscal year (audited financials alternative).

From at least 2018 through 2021, the Funds allegedly entered into several investment contracts whereby they issued loans to an ECM affiliate, which used the proceeds of those loans to acquire real estate for the Funds. ECM's principal oversaw those transactions, and had access to the loan proceeds and the Funds' money. ECM also allegedly held paper membership interests in the Funds owned by its clients at its principal place of business. The SEC alleged that ECM therefore had custody of the funds and securities of the Funds as well as custody of its clients' membership interests in the Funds.

From 2018 through 2021, ECM allegedly failed to engage an independent public accountant to conduct surprise examinations and, with respect to the Funds, failed to comply with the audited financials alternative. ECM also allegedly failed to comply with the requirement that investment advisers adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, including the custody rule.

On account of this conduct, the SEC alleged ECM violated Section 206(4) of the Advisers Act, and Rules 206(4)-2 and 206(4)-7 thereunder.

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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