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SEC to Investment Advisers: Do What You Promise, or Face Massive Penalties

The SEC slammed Barclays Capital Inc. ("Barclays") with $97 million dollars of remediation, penalties and disgorgement last month in a case that should be ringing alarm bells throughout the alternative investment fund industry. The case, In the Matter of Barclays Capital Inc. (SEC File Number 3-17978), provides a clear warning that the SEC is not limiting itself to conflicts of interest violations, but is taking a hard look at how investment advisers describe the services they perform for clients, and severely punishing gaps between promise and practice.

The case arose out of a Barclays wrap fee program, and most commentators have analyzed the case in the context of that type of program. However, nothing about the case is unique to a wrap fee program, and in this case the SEC did not focus on the wrap fee elements of the program or the nature of the clientele. Consequently, all investment advisers need to consider the implications of the SEC's findings.

The essence of the case was that Barclays was not providing the investment advisory services that it had promised to clients in its marketing materials and Form ADV – in this case, monitoring the performance of sub-advisers participating in Barclays' wrap fee program. Interestingly, the SEC did not find a direct link between the deficient services and client losses, or that Barclays was benefitting at its clients' expense. The closest to direct harm that the SEC found was that certain sub-advisers whom Barclays was not monitoring as closely as in the past had underperformed market benchmarks.

Alternative fund investment advisers should be especially concerned that the SEC apparently now is focusing on the gap between services promised and services performed. Most alternative funds, such as private equity funds and hedge funds, are marketed as blind pools, in which the investor is entrusting his money to the advisor not for a share of a determined pool of assets, but based on the adviser's expertise and investment methodology and discipline. Accordingly, a great deal of the marketing materials for such funds focusses on the investment advisor's investment and asset management practices. However, given the Barclays case, advisers who modify or deviate from the promised regimen may find themselves under scrutiny from the SEC.

The Select Advisors Program

The case centers on a wrap fee program called the "Select Advisors Program" and the time-period September 2010 through December 2014. Under the Select Advisors Program, Barclays identified, selected and recommended to its investment advisory clients third-party investment advisers to manage and invest client assets in specific strategies. Third-party managers were categorized by Barclays Capital as "Elite", "Select" or "Quant Select". The "Elite" managers were to receive the highest due diligence, "Select" managers less, and the "Quant Select" pass/fail monitoring based on an algorithm and historical performance. (In the Matter of Barclays Capital Inc., Cease and Desist Order, at paragraph 8).

The Select Advisors Program had assets under management ("AUM") that ranged from $5.6 billion in mid-2011 to $6.9 billion in September 2014. The wrap fees for the program ranged from 0.32% to 1.75% of

AUM depending on strategy and covered due diligence, investment advisory, custody, administrative and execution services. (Id. at paragraph 3).

Barclays had represented to its investment advisory clients that it would perform ongoing monitoring of the third-party managers in client agreements and in Part 2A of its Form ADV (the "Brochure"). For example, in September 2010, the Brochure stated that Barclays would review managers and strategies "'on an ongoing basis based on various quantitative and qualitative factors, including performance, adherence to investment strategies and investment objectives, and material business changes, to determine whether they continue to remain suitable to be commended to Barclays Wealth clients.'" (Id. at paragraph 7). These representations remained substantively the same in the March 2013 and March 2014 Brochure updates. The Select Advisors Program marketing materials stated that "Barclays Capital selected third-party managers using 'a stringent due diligence process, where candidates are evaluated using both quantitative and qualitative criteria,' and subjected them to ongoing due diligence." (Id.)

Barclays' Manager Research and Selection group ("MRS") was responsible for research, due diligence and monitoring of the third-party managers.

Violations and Punishment

Failure to Perform Due Diligence

The SEC found that MRS was "understaffed and under-resourced" from 2011 through 2014 (Id. at paragraph 17) and "fell behind in its ongoing monitoring (i.e. on-site visits to managers, quarterly reviews and periodic write-ups) of certain Select managers and of a small number of highly customized strategies classified as Elite." In early 2012, MRS also stopped performing ongoing due diligence of Quant Select Mangers. "For this reason, as time went on, the gaps in MRS's due diligence widened." (Id. at paragraph 22).

The SEC thus held that from September 2010 to December 2014, Barclays "falsely represented in its client agreements, brochures, and marketing materials that it was performing initial due diligence and ongoing monitoring of all third-party managers and their respective investment strategies in the Select Advisors Program, when, in fact, it was failing to do so with respect to certain strategies designated as Select, Quant Select, and a small number of highly customized Elite strategies." (Id. at paragraph 23).

Lack of policies and procedures

The SEC found that Barclays did not comply with Rule 206(4)-7 of the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), requiring adoption and implementation of written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act and the rules thereunder, from September 2010 to approximately February 2013 because it "failed to adopt written policies and procedures reasonably designed to ensure that its due diligence disclosures accurately reflected its actual practices," (Id. at paragraph 32), and from February 2013 to December 2014, because it failed to effectively implement the policies and procedures it had adopted.

The SEC also found that from September 2010 to approximately June 2013, Barclays did not have any polices or procedures in place to ensure that representations to wrap fee clients "accurately described its manager research and due diligence function." (Id. at paragraph 33). And, although Barclays established a committee including members of legal, compliance, MRS and business groups to review MRS's investment ratings, the SEC found that, "in practice" the committee "failed to provide an effective control over the due diligence function. The committee did not address Barclays Capital's longstanding due diligence failures in the wrap fee program until November 2014." (Id. at paragraph 33).

Accordingly, the SEC found that Barclays (1) willfully violated Section 206(2) of the Investment Advisors Act, which prohibits an investment advisor from engaging in any transaction, practice or course of business that operates as a fraud or deceit upon a client or prospective client, (2) willfully violated Section 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder, which require, among other things, the adoption and implementation of written policies and procures reasonably designed to prevent violations of the Act and the rules thereunder and (3) willfully violated Section 207 of the Investment Advisers Act by making untrue statements of material facts in reports filed with the SEC.

To settle the matter, Barclays was, among other things, (1) required to disgorge the entire amount of advisory fees earned by the strategies in which due diligence was deficient during the period at issue ($37 million), (2) required to offer remediation to clients invested in strategies that were receiving deficient due diligence in an amount equal to the amount by which such strategies underperformed market benchmarks ($3.4 million), and (3) pay a $30 million civil monetary penalty.

Implications

Recent SEC actions against fund investment advisers all involved clear conflicts of interest in which the adviser or its owners directly benefitted at the expense of the client by, for example, charging undisclosed fees to clients or shifting expenses to clients. In the Barclays case, however, the SEC found wrongdoing because the adviser *inadequately* delivered promised services. Prior to this case, based on the SEC's existing enforcement actions, fund investment advisers knew any of the following created a high risk of an SEC enforcement action:

1. Undisclosed fees and expenses.
2. Impermissible shifts and misallocation of expenses.
3. Failure to disclose conflicts of interest.

On the flip side of the red lines noted above, there was a practical expectation that a deficiency would not trigger an enforcement action so long as:

1. Applicable policies and procedures were in place and being reasonably followed.
2. There was a good faith and reasonable attempt to provide promised services.
3. There was no proximate link between a compliance failure and investor loss.

The Barclays case became an enforcement action even without any of the red lines identified above, and despite mitigating factors that might have suggested a zone of safety. Specifically:

1. There was no element of self-dealing.
2. Barclays was performing due diligence during the entire period at issue.
3. Policies and procedures were in place for at least part of the time-period at issue.
4. The SEC did not identify any actual losses to investors.

What makes the Barclays case so potentially troubling for fund investment advisers is that the SEC looked beyond the simple fact that due diligence was being performed, and into the details of how and when the due diligence was being performed and whether the due diligence actually performed matched the promises that had been made to investors. For example, the SEC found that Barclays "continually understaffed and under-resourced" MRS and that the number of people performing due diligence declined from five at the start of the program, to "only three to four staff members and, at times . . . only two staff members." (Id. at paragraph 17). This decline in resources led to a decline in the amount of due diligence for certain advisers. This was sufficient, in the SEC's judgment, to make Barclays' disclosure to investors and the SEC materially false.

The SEC also found that implementing policies and procedures is not enough to avoid sanction if the policies and procedures prove ineffective to avert the wrongdoing. Thus, although Barclays had formed a committee in June 2013 that included members of legal, compliance, MRS and business groups to oversee the due diligence process, the SEC found the violations continued until the end of 2014 because the committee had been ineffective.

Paradoxically, the SEC did not present any evidence that the lack of due diligence directly harmed investors. In fact, the only economic harm the SEC identified was that "certain of" the Select and Quant Select Strategies that Barclays was insufficiently monitoring under-performed market benchmarks by approximately $3.4 million (Id. at paragraph 26).

Why Fund Advisers Need to Take Heed

Alternative investment fund advisers attract investors by presenting an investment thesis, a track record, a set of skills, and investment and asset management procedures that convinces investors that the investment adviser is the right adviser to exploit an opportunity. Investment advisers have long been on notice that the SEC closely scrutinizes investment performance reporting and punishes misreporting severely. Now they are also on notice that the SEC is looking at the description of investment and asset management procedures with a similar skeptical eye.

Based on the Barclays case, investment advisers need to take a hard and honest look at the description of their investment and asset management methodology in both their marketing materials and Form ADVs. Advisers should be prepared to provide substantive proof that they are providing the services described and to justify changes in methodology and resources, such as changing from quarterly reviews to semi-annual reviews, or the reduction or elimination of on-site visits. In addition, advisers should have detailed policies and procedures governing investment and asset management practices that, among other things, clearly articulates the appropriateness of the chosen policies and procedure given the client and strategy and ensure the description of policies and practices in marketing materials and Form ADVs are complete and accurate. Changes to policies and procedures should be carefully described in Form ADVs and marketing materials.

Advisers should also be aware that SEC may judge the timeliness of response to compliance issues. In this case, the SEC found Barclays' response to identified compliance issues to be too slow. The SEC noted that the head of MRS notified the compliance department that "resource constraints threated to impact" his ability to conduct due diligence during a 2014 review. This finding was noted in a report that was circulated to senior management during the first quarter of 2014 and finalized in June 2014. "But no new resources or staffing were provided to MRS until late 2014, after certain due diligence failures that had already occurred came to the attention of [senior management]." (Id. at paragraph 19). The SEC was not forgiving of this delay.

The SEC actions in this case are not surprising given the SEC's increased scrutiny of investment advisers over the last several years. Accordingly, advisers must take heed and subject their disclosure and actual practices to a cold assessment. The clear implication of this case is that advisors must do what they say, and that the absence of adequate resources to do so will be severely punished. In particular, fund advisers should recognize that this case, along with In the Matter of Apollo Management V, L.P. et al (File number 3-17409), In the Matter of Blackstone Management Partners L.L.C et. al. (File number 3-16887), In the Matter of Kohlberg Kravis Roberts & Co., L.P. (File number 3-16656) and In the Matter of Blackrock Advisors, LLC and Bartholomew A. Battista (File number 3-16501) constitute a powerful warning that common practices need to change at the peril of severe financial penalty.

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About Eric Rubenfeld

Eric Rubenfeld is a partner with Fragner, Seifert Pace & Mintz, LLP (f/k/a Fragner Seifert Pace & Winograd, LLP), a boutique law firm serving the legal needs of emerging and institutional business clients. Eric specializes in advising alternative investment advisers on all aspects of their business, including operational and transactional matters (including joint-ventures, financings, asset acquisitions and dispositions, fund formation and fund raising), dispute resolution, and regulatory compliance. Eric draws on his experience as a former principal, general counsel and CCO at multiple alternative investment firms and at top international law firms to deliver business savvy and cost-effective legal service to his clients.

Before returning to private law practice with FSPM in 2017, Eric spent over a decade as the general counsel and chief compliance officer of multiple multibillion-dollar institutional investment advisers specializing in private and public equity investments in real estate and corporate debt and equity. In addition to handling legal and compliance matters, Eric also managed HR and risk management and served on the management, investment, valuation, and risk and conflict committees.

Eric began his legal career practicing corporate law and litigation in New York City and Washington, D.C., including stints at Fried, Frank, Harris, Shriver & Jacobson and Arnold & Porter. Eric advised leading financial institutions, including Goldman Sachs, Morgan Stanley, Merrill Lynch and J.P. Morgan, in connection with their securities and structured product offerings, and represented private and public companies in litigation in both federal and state courts.

Eric earned his J.D., cum laude, from the Harvard Law School in 1995 and his B.A., magna cum laude and with college and departmental honors, from UCLA in 1991.

Eric recently:

- Represented a co-general partner in the formation of a new real estate private equity fund adviser and the formation of its first co-mingled fund
- Represented a private equity fund in assembling, financing, and selling a $300+ million data center portfolio in the United States and Canada
- Represented a private equity fund in $200 million of secured, property financings
- Represented a private equity fund in a $75 million shopping center construction loan
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About Fragner Seifert Pace & Mintz, LLP

Fragner Seifert Pace & Mintz, LLP was founded nearly 20 years ago with one simple mission: to provide the highest quality legal services to real estate and business clients to help them achieve their business objectives with maximum efficiency. To accomplish this goal, we staff matters leanly with highly experienced attorneys who use time-tested strategies grounded in decades of experience to achieve efficient execution. Our quality over quantity approach results in lower cost and superior execution that yields benefits to our clients on an immediate, short-term and long-term basis.

Our core practice is representing sophisticated owners, operators, investors, lenders, and advisers in real estate and business matters, including entity formation and structuring, joint ventures, capital raising and financing, asset and stock acquisitions and dispositions, mergers and acquisitions, and leasing and operations, across the United States.

Our attorneys are licensed to practice law in California, Illinois, New Jersey, New York, Pennsylvania, and Texas.