

SEC Enforcement Case Summary Private Fund Conflicts of Interest & Custody Violations

On September 20, 2024, the SEC announced charges against private equity and venture capital fund manager, Closed Loop Partners LLC, for failing to properly disclose and gain consent for certain client loan transactions involving conflicts of interest, and for failing to deliver required audited financial statements to private fund investors in a timely manner. The firm consented to a \$250,000 penalty. According to the SEC order, Closed Loop caused a holding company formed to hold one private equity fund's interest in a portfolio company to obtain a short-term bridge loan from a lender to finance an equity investment in the portfolio company. However, Closed Loop allegedly failed to disclose that its Executive Director and Chief Compliance Officer, who negotiated the loan, also sat on the board of directors of the lender's parent company. To complete the portfolio company purchase, the private equity fund needed an additional \$5 million but did not have sufficient cash on hand. According to the SEC order, the fund had already exhausted its line of credit collateralized by \$18 million in capital commitments.

After unsuccessfully attempting to obtain financing from other parties, Closed Loop caused the private equity fund, through the holding company, to take out a short-term unsecured \$5 million bridge loan from the lender at an annual interest rate of 24% (or a monthly rate of 2%). Under the terms of the bridge loan, the lender also received warrants allowing it to purchase an equity interest in the holding company for a price of one dollar per share. According to the SEC order, the holding company repaid the loan eight months later, including a total of \$428,370 in interest, and the lender subsequently exercised the warrants, diluting the private equity fund's equity interest in the holding company. When the portfolio company was later sold, the lender earned an additional profit of \$623,124 from the equity interest it had obtained in the holding company by exercising the warrants. The SEC noted that as a result of the combined value of the interest payments and the exercised warrants, the loan generated a total of \$1,051,494 in effective interest for the lender, or more than 20% of the initial principal, in an eight-month period.

In addition, the SEC charged Closed Loop with failing to disclose conflicts of interest related to two additional short-term loans that it and a related entity made to two other private funds the firm advised, including a venture capital fund and fund of one. The SEC noted that because Closed Loop controlled the parties on both sides of the loans to these funds, these transactions were subject to inherent conflicts of interest that Closed Loop was obligated to disclose. While Closed Loop and its affiliate did not charge interest on the loans, the SEC alleged that the loans nevertheless gave rise to a conflict of interest because Closed Loop and the related entity became creditors of the two funds until the loans were repaid.

The SEC order noted that the firm was required to disclose conflicts of interest in each case either to a limited partner advisory committee ("LPAC") or to each of the fund's limited partners and obtain consent prior to such transactions. Closed Loop had not yet formed an LPAC for these three funds by the time of the relevant transactions, and the firm did not fully disclose the material facts concerning the conflicts to the funds' limited partners. The SEC case noted that after its investigation as completed, Closed Loop made disclosures concerning these three loan transactions to, and the transactions were ratified by the relevant LPACs and the fund of one's sole limited partner.

Closed Loop was further charged with violations of the Custody Rule 206(4)-2 of the Investment Advisers Act for failing to engage an independent, PCAOB-registered accounting firm on a timely basis to

conduct an annual audit of the financial statements for its fund of one and certain co-investment vehicles. Furthermore, because Closed Loop did not satisfy the requirements of the audited financial provision of the Custody Rule, Closed Loop was required to comply with other provisions of the rule, which it failed to do. For example, Closed Loop did not ensure that funds and securities were verified by actual examination each year by an independent public accountant at a time chosen by the accountant without prior notice or announcement to the adviser, in accordance with Rule 206(4)-2(a)(4).

This case provides several important lessons for private fund managers. As noted in other recent cases involving undisclosed conflicts of interest, the SEC expects that all conflicts be fully disclosed to and consent obtained from a fund's LPAC or, if there is no LPAC or an LPAC has not yet been formed as of the date of a related party transaction, all limited partners. It is not sufficient to disclose conflicts of interest after the fact without the requisite disclosure and consent. This is expected regardless of whether fund governing documents specifically require LPAC consent.

Fund audits are expected not only for primary funds, but also for co-investment vehicles and funds of one where an investment adviser through its affiliated general partner is deemed to have custody. This case does not indicate whether the firm made an (unsuccessful) argument that the vehicles noted in the case were not investment advisory clients. However, if such vehicles are (or arguably should be) deemed advisory clients an audit is generally required. It is important to note that if an audit is not required by the governing documents for such vehicles, then the investment adviser must comply with all other provisions of the Custody Rule, including 1) maintaining all funds and securities (including private securities) at a qualified custodian; 2) providing custodian notification to investors; 3) ensuring the custodian delivers quarterly statements to investors; and 4) obtaining a surprise examination by an independent accountant.

See Summary - <https://www.sec.gov/enforcement-litigation/administrative-proceedings/ia-6712-s>