

SEC charges private fund administrator with gatekeeping failures

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Abstract

Purpose – To explain a set of recent US Securities and Exchange Commission (SEC) administrative settlements targeting fund administrators and to alert fund administrators and other financial service providers to their growing “gatekeeper” obligations.

Design/methodology/approach – This article explores the factual and legal contours of SEC administrative settlements with a fund administrator, as well as related enforcement actions against investment managers, to better understand the affirmative steps the SEC is expecting financial service providers to take to help root out fraud and misappropriation in the financial services sector.

Findings – The SEC’s administrative settlements with this fund administrator illustrate the SEC’s expanding focus on the “gatekeeper” function and signal the intent of the SEC to impute culpability for wrongdoing to fund administrators and other financial service providers simply for not doing enough to root out fraud and misappropriation in the financial services sector.

Originality/value – This article contains valuable information about recent SEC enforcement activity and practical guidance from experienced white collar, securities, and investment management lawyers.

Keywords Gatekeeper, Due diligence, US Securities and Exchange Commission (SEC), Administrative action, Fund administrator, Net asset value (NAV) package

Paper type Technical paper

In June 2016 the Securities and Exchange Commission (SEC) announced two administrative settlements with a fund administrator that provided accounting and fund administration services to several private funds based on its alleged failure to heed red flags and correct faulty accounting by two private fund managers. The fund administrator, Apex Fund Services (US), Inc. (Apex) agreed to pay more than \$350,000 to settle the SEC’s charges.

Apex served as the fund administrator for two private fund managers, ClearPath Wealth Management (ClearPath) and EquityStar Capital Management (EquityStar), at varying times between 2011 and 2014. Pursuant to its contracts with the various private funds, Apex was required to perform a variety of services, including, but not limited to: keeping the accounts and records of the funds; arranging the issue, redemption and repurchase of fund interests; calculating fees and other allocations payable to the funds in accordance with offering documents; preparing financial statements for the fund in accordance with generally accepted accounting principles; liaising with the funds’ auditors with respect to annual financial statements; determining and issuing statements detailing the value of each investor’s fund interest; and providing monthly account statements to investors. The SEC alleged that in carrying out these functions Apex missed or ignored clear indications of fraud perpetrated by both private fund managers, making Apex a “cause”[1] of that fraud under Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder[2].

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Investigation background – ClearPath

With respect to ClearPath, the SEC specifically alleged that, despite being notified in July 2012 of undisclosed brokerage accounts dating back to August 2011, one with a negative balance of \$4.1 million generated by margin borrowing against another fund account, Apex continued to issue net asset value (NAV) packages, balance sheets, profit and loss statements, and capital account balances to both ClearPath and its auditors reflecting the fund's invested balance (\$4.8 million) only.

According to the SEC, Apex did not make any adjustments to the previously issued NAV packages or capital account statements after learning of the margin accounts. This resulted in the auditors issuing an unqualified opinion overvaluing the investment balance by more than \$4 million. The SEC also claimed that Apex failed to account for loan balances and cash commingling transactions made in violation of fund offering documents in ClearPath's NAV packages and capital account statements, and recorded unsupported investment amounts "due from investment manager" as repaid when ClearPath simply transferred those funds from another fund it managed. In May 2015, concerning related subject matter, the SEC filed fraud charges against ClearPath and its owner, Patrick Churchville (Churchville), under Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, among others, alleging that Churchville misappropriated investor funds and then lied to investors to lull them into believing their investments were safe.

Investigation background – EquityStar

With respect to EquityStar, the SEC alleged that Apex accounted for EquityStar owner Steven Zoernack's (Zoernack) withdrawals of more than \$1 million directly from the funds as receivables (fund assets) without any evidence that EquityStar and Zoernack were willing or able to repay the amounts. The SEC also alleged that Apex provided monthly investor statement NAVs to investors on behalf of Zoernack and EquityStar that, by virtue of the undisclosed withdrawals, materially overstated the value of the investors' holdings in the funds. According to the SEC, Apex continued to account for Zoernack's withdrawals as receivables for a period of almost two years even though, according to the SEC, Apex knew or should have known that Zoernack would not repay the money, during which time Zoernack continued to make withdrawals.

The SEC claimed that Apex should have known that Zoernack would not repay the amounts he withdrew based on two communications received from EquityStar's previous fund administrator warning Apex about investor complaints of "mounting losses", as well as Zoernack's past felony fraud convictions, of which Apex would have been aware had it conducted due diligence on Zoernack at the time their engagement began. As with the SEC's charges with respect to ClearPath and Churchville, the SEC charged Zoernack and EquityStar with making false and misleading statements to investors and making unauthorized fund withdrawals under Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, among others.

Although the SEC did not allege that Apex directly participated in any of ClearPath's or EquityStar's wrongful conduct, the SEC concluded that, as a result of Apex's failure to act upon knowledge it possessed regarding both the ClearPath and EquityStar schemes, Apex was a cause of the investment managers' violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

SEC's message

In charging Apex, the SEC is highlighting its expectation that fund administrators take affirmative action to ensure that fund records provide accurate information about the value and existence of fund assets. Indeed, then-SEC Division of Enforcement Director Andrew Ceresney explained that liability was specifically ascribed to Apex because "Apex failed to

live up to its gatekeeper responsibility and essentially enabled the schemes to persist at each of these advisory firms until the SEC stepped in”.

The SEC’s action against the fund administrator here should serve as a warning to all gatekeepers, including service providers, compliance professionals and auditors, that the SEC will use negligence-based securities laws to hold service providers responsible, especially where indications of fraud are ignored.

Notes

1. Section 203(k) of the Investment Advisers Act of 1940 (Advisers Act), the provision under which the cease-and-desist actions were brought, allows the SEC to impose a cease-and-desist order upon any person that is, was, or would be a cause of another’s violation, due to an act or omission the person knew or should have known would contribute to such violation.
2. Section 206(2) of the Advisers Act prohibits any investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder make it unlawful for any investment adviser to a pooled vehicle to make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made not misleading, or otherwise engage in any act, practice or course of business that is fraudulent, deceptive or manipulative.

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